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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Gately & Associates,
LLC and James P. Gately, CPA,

Respondents.

PCAOB File No. 105-2008-001

FINAL DECISION

June 4, 2009

Appearances

William F. Ryan, Esq., Washington DC, for the Division of Enforcement and Investigations.

Roddy B. Lanigan, Esq., Lanigan & Lanigan, PL, Winter Park, FL, for Respondents.

I.

Gately and Associates, LLC ("Gately LLC"), a registered public accounting firm, and James P. Gately ("Gately") appeal from a hearing officer's decision permanently revoking Gately LLC's registration with the Board and permanently barring Gately from association with any registered public accounting firm for failing to cooperate in a PCAOB inspection in violation of Rule 4006. The hearing officer disposed of all matters in the case by granting a motion for summary disposition filed by the Division of Enforcement and Investigations ("Enforcement"). We base our findings on a *de novo* review of the record. We find that Respondents failed to cooperate in a PCAOB inspection in violation of Rule 4006, and that it is in the public interest to permanently revoke the registration of Gately LLC and to permanently bar Gately from association with a registered public accounting firm.

II.

Gately LLC is a public accounting firm licensed under Florida law to engage in the practice of public accounting. It has been registered with the PCAOB pursuant to Section 102 of the Sarbanes-Oxley Act of 2002 (the "Act") since November 2003. Gately is a certified public accountant also licensed in Florida. At all relevant times, Gately has been the managing member, sole owner, president and sole employee of Gately LLC, and an associated person of a registered public accounting firm as defined in Section 2(a)(9) of the Act and Rule 1001(p)(i).

A. Inspection Efforts

In February 2007, the PCAOB Division of Registration and Inspections ("Inspections") began efforts to conduct an inspection of Gately LLC, in accordance with Section 104 of the Act and Rules 4000 and 4001. On February 15, February 23, and March 9, 2007, Inspections staff left voice mail messages on Gately's cell phone requesting that he contact Inspections to provide information concerning Gately LLC, updated to reflect events that had occurred since the prior inspection of Gately LLC in 2004. Gately does not recall receiving any of those messages, and he did not respond to them.

On May 23, June 4, and June 7, 2007, more than two months later, Inspections staff again left messages for Gately on his cell phone, this time informing him that Inspections staff planned to begin the field work for its inspection of Gately LLC on August 13, 2007, and asking Gately once more to contact Inspections to provide updated information regarding Gately LLC.

On June 11, 2007, Gately contacted Inspections staff and explained that he was in a 90-day alcohol rehabilitation program and would not be available for an inspection of Gately LLC on August 13. Inspections staff agreed to reschedule the inspection. Inspections subsequently decided to schedule the inspection field work to begin on October 1, 2007, and notified Gately of that date on July 10, through a voice mail message.

On September 12, 2007, Gately spoke to Inspections staff by telephone. Although there is disagreement as to the precise content of the call, it is undisputed that Gately advised Inspections that he would have to travel to obtain the files needed for the inspection and that Inspections again agreed to postpone the inspection. Inspections rescheduled the inspection for November 5, 2007.

Also on September 12, Inspections staff sent Gately, by email, an Issuer Information Form ("IIF"), which sought information concerning Gately LLC's public company audit clients. The information sought ranged from the very basic, such as the name, location, and industry of Gately LLC's audit clients, to the more detailed, such as the release date of Gately LLC's audit reports.

In the September 12 email, Inspections staff requested that Gately complete the IIF and provide it to Inspections as soon as possible and no later than September 20, 2007. Inspections staff also informed Gately that once it received the completed IIF, "we will try to let you know which engagements we have selected as soon as possible so that you will have plenty of time before the November 5, 2007 planned inspection date to retrieve the work papers from storage." Inspections staff also informed Gately that "it is not likely that we will be able to accommodate a request to move the inspection to a date any later in the year."

Respondents did not complete and submit the IIF. During October 2007, Inspections staff left Gately five voice mail messages and sent him four emails and three letters requesting that he complete and return the IIF. It is unclear whether Gately received any of these communications, other than the October 31 letter discussed below, which Gately acknowledged.

In the last of the letters, sent on October 31, 2007, Inspections staff advised Gately:

> failure on your part either to provide all the information requested of you or to allow the inspection team to commence field work of the inspection of your firm on Monday November 5, 2007 may result in this matter being referred to the PCAOB's Division of Enforcement and Investigations. This could result in disciplinary action for failure to cooperate with an inspection as required by PCAOB Rule 4006, even if you later permit the inspection.

On October 31, 2007, even though Respondents had not completed and returned the IIF, Inspections staff also sent Gately an email advising him that Inspections had selected two specifically-identified Gately LLC audit engagements for review, and that at the November 5 inspection meeting, "you will need to provide to us all your workpapers for the engagements identified . . . and during this meeting we will discuss your firm's quality control policies and practices and work with you to schedule interviews/meetings related to each engagement to be inspected." Gately subsequently indicated, in a November 3, 2007 email, that he had not received notice of the two engagements that Inspections wanted to review, and, in a November 5 email response, Inspections staff again identified the two engagements.

On November 2, 2007, one business day before the field work was to begin, Gately sent Inspections staff an email stating, "Notice of not confirming the inspection and will be preparing a deregistration form sometime next week." In the email, Gately said:

> When I first spoke with [an Inspections staff member] I was going to deregister from the PCAOB as I was in rehab and would be spending months there and not able to participate in an inspection. I then contacted [the staff member] later to see if she would give me a chance to have files collected for me and if it did not work out for the timetables I would deregister.

In the email, Gately also explained that he "would have to travel to get to files and fill out the paperwork," and stated that in order to travel he "need[ed] travel permission from [his] probation officer which will not be timely." The email concluded, "Given your letter I am going to fill out the form to deregister."[1/]

In response, Inspections staff sent Gately a letter dated November 2, 2007, indicating that, based on his November 2 email, Inspections understood that Gately LLC intended to file a Form 1-WD, Request for Leave to Withdraw from Registration, pursuant to Rule 2107. Inspections stated that it would postpone the field work for the inspection until November 26, 2007, so that Gately LLC would have time to do that, and that Inspections would further postpone the inspection if Gately LLC filed a Form 1-WD by that date. But the letter also warned that if Gately LLC did not file a Form 1-WD by November 26:

> we will commence the inspection field work on that date. In that event, you should have the issuer information form and all of the other information we have requested available for us on November 26, 2007, as well as audit engagement file(s) for the two engagements previously communicated to you, including the audit work papers, permanent files and report files and any other relevant documentation supporting the firm's audit opinion.

[1/] "Your letter" appears to refer to the October 31, 2007 letter from Inspections staff.

The letter again warned that failure to provide all requested information or to allow the inspection to begin on November 26 might result in the matter being referred to Enforcement, which could lead to disciplinary action.

On November 5, 2007, Gately advised Inspections staff, by email, "If you are willing, I can go to Orlando to search the storage units for the files and give you an answer on withdrawal a week from today if the files are easily accessible." Inspections staff responded, in an email dated November 7, 2007, that "PCAOB is not in a position to advise you whether to go to Orlando, to withdraw from registration or to take any other course of action," but reminded Gately that if Gately LLC did not file a Form 1-WD to withdraw from registration by November 26, 2007:

> the inspection will commence on that date and you should have the issuer information form and all the other information we have requested available for us on November 26, 2007, as well as audit engagement file(s) for the two engagements previously communicated to you, including the audit work papers, permanent files and report files and any other relevant documentation supporting the firm's audit opinion . . . .

In response, Gately sent Inspections staff an email on November 7, 2007, stating, "Got it. Going to Orlando to pick up the files."

On November 19, 2007, Inspections staff sent Gately an email asking him to either confirm the November 26 inspection field work date or indicate that Gately LLC intended to request leave to withdraw from registration. Gately responded the same day with an email stating, "My intention is to have the two companies available on the 26th. I returned with them from Orlando this past Saturday. I will complete the listing of all companies on the template . . . ." Gately also provided a new residential mailing address.

On November 22, 2007, however, Gately emailed Inspections staff, stating that he would "not be available for the inspection," because "[w]hen arriving back to the Miami area I was confronted with . . . the old house having had fire damage." In a subsequent email, also on November 22, Gately advised Inspections staff that "unfortunately my stuff is in the old house." Inspections staff responded with an email expressing sympathy and asking Gately to call the next day, Friday, November 23, "so we can discuss how to proceed."

On Monday, November 26, the day the inspection was to have begun, Inspections staff sent Gately an email stating that they "did not hear from you on

Friday," and again asking Gately to call "so we can discuss your situation." To this email, Gately responded on November 26, "I will call." According to Gately, however, he had limited communication ability and was completely preoccupied with finding a new home; in any event, he did not call Inspections staff.

On November 27, 2007, Inspections staff sent Gately another letter stating that it was "imperative" that he call Inspections no later than the close of business on November 28, 2007, so that the field work for the inspection of Gately LLC could be rescheduled. The letter warned Gately that failure to contact Inspections staff by that deadline could result in a disciplinary action for failure to cooperate with an inspection.

Gately called Inspections staff on November 28 and Inspections agreed to reschedule its field work for the inspection to December 10, 2007. Inspections also agreed to conduct a "PCAOB-based inspection," which allowed Respondents to send all requested materials to the PCAOB's offices in Atlanta and participate in telephone interviews, rather than appearing in person.

On November 29, 2007, Inspections staff sent Respondents a letter confirming the December 10 inspection date and again requesting that they complete and return the IIF. In order to allow Inspections to proceed on December 10, the letter also requested that Respondents provide to Inspections by December 7, 2007: (a) copies of the audit engagement files for the two engagements that Inspections had selected for review; and (b) other documents and information described in a "Data Request" form enclosed with the letter. The Data Request sought both basic and detailed information about Gately LLC and its operations and personnel.

Inspections staff followed up the November 29 letter with voice mail messages for Gately on December 4 and 6, 2007, and an email to Gately on December 7, 2007. The email noted that Inspections had "not yet received the copies of your audit work papers and the other requested information, which were due to us today."

Inspections heard nothing more from Gately until December 10, 2007, the date scheduled for the inspection. On that day, Gately sent Inspections staff an email stating that he "[j]ust saw your message"; that there had been an "[u]nexpected slow up on my side"; and that he would call Inspections staff and provide an update.

Gately did not call Inspections staff or provide an update. On December 20, 2007, Inspections sent Respondents another letter, which recounted the history of Inspections' efforts to schedule an inspection of Gately LLC; reiterated that it "is imperative that you submit the requested information, including copies of the audit engagement files for the two engagements the staff selected and other information the staff requested in its November 29 letter . . . as soon as possible," with a December 28, 2007 deadline; and warned that Respondents' failure to meet the deadline "will result in this matter being referred to" Enforcement and could lead to disciplinary proceedings for failure to cooperate with an inspection, "even if you later provide such copies of the audit engagement files and the other requested information."

Respondents did not respond to the December 20 letter until January 2, 2008, when Gately sent Inspections staff an email in which he stated that he had moved from the address to which the December 20 letter was sent; that "someone else" signed for the letter at that address; and that "[s]ince I found out about this deadline letter today I . . . request . . . to change the date and work with the inspection team. My intention was to cooperate with the team." Gately included with his email an Expedia.com airline itinerary showing that he had traveled to Chicago, Illinois during the period December 21-30, 2007.

On January 3, 2008, Inspections staff sent Gately an email with an attached letter advising Respondents that Inspections'

> demand for the requested materials (including the copies of the audit engagement files for the two engagements the staff selected and the other information that the staff had requested from you) still stands, and we encourage you to provide the materials and permit the inspection as soon as possible. However, for purposes of the timeliness of your compliance we will not revise the deadline described in our December 20, 2007 letter, and our position remains as stated in that letter.

Gately later confirmed that he had received the email and was able to open the letter.

On April 4, 2008, the Board instituted this proceeding, alleging that Respondents violated Rule 4006 during 2007 and 2008. As of that date, Respondents had not provided any of the information requested by Inspections. On August 15, 2008, Respondents provided Inspections with an IIF.[2] According to a cover letter from

[2] Respondents did not notify the hearing officer about the submission of the IIF, and raise the fact that they provided it for the first time in their reply brief on appeal.

Respondents' attorney, the IIF was provided in response to a request from Inspections via e-mail "on June 5."[3]

B. Respondents' Circumstances During the Relevant Time Period

Gately is Gately LLC's only employee. From April 18, 2007 to April 24, 2007, Gately was undergoing initial treatment for alcoholism in a detoxification facility. From April 25, 2007 to July 19, 2007, Gately was in an in-patient residential detoxification clinic in the Miami area, where he was treated for severe alcoholism.

After his in-patient treatment, Gately was in out-patient treatment from July 20, 2007 until February 29, 2008. His treatment included weekly interaction at a clinic, a monitored dietary and exercise regimen, and assigned reading. He was also required to attend daily Alcoholics Anonymous meetings and bi-weekly therapy sessions.

During his time in out-patient therapy, Gately lived in a "three-quarters way" house, as recommended by Gately's psychotherapists. Such houses have live-in monitors who oversee the patient's day-to-day living environment. In February 2008, Gately reached a level of health at which his psychotherapist recommended that he was ready to move out of the "three-quarters way" house.

In late August 2007, against the advice of his therapists, Gately traveled to Orlando, Florida in an attempt to retrieve his work files, which were in storage at the home of one of Gately's colleagues. Gately relapsed during his trip and the colleague refused to release the files on account of Gately's noticeable intoxication. The police were called and Gately was arrested.

On September 27, 2007, Gately was placed on two years probation by a Florida state court, apparently for an alcohol-related motor vehicle violation. The probation conditions required Gately to obtain the permission of his probation officer to travel outside his county of residence, and the procedure to obtain permission usually required a minimum of two weeks notice for travel out of state and one to two weeks notice for in-state travel outside his county of residence. As noted above, Gately's files were in storage in Orlando, which was outside his county of residence.

[3] Other than this reference in a letter attached to Respondents' reply brief on appeal, there is no evidence in the record concerning what, if anything, Inspections communicated to Respondents on June 5, 2008 concerning the request for the IIF.

In November 2007, Gately apparently obtained the required permission and again traveled to Orlando, where he retrieved at least some of his files. Subsequently, however, there was a fire in one of Gately's residences and he lost files for the two audit clients Inspections had identified. According to Gately, he then began planning another trip to Orlando to obtain materials to supplement and complete his now incomplete set, and this was the "unexpected slow up" referred to in his December 10, 2007 email to Inspections.

Gately did not respond to Inspections' December 20, 2007 letter until January 2, 2008 because he was in Chicago visiting family and contemplating a move back home. Gately asserted that after receiving Inspections' January 3, 2008 letter, he "understood that [the] matter would further be handled by the PCAOB's enforcement division given that the deadline of December 28 had already [passed]."

C. Gately LLC's Audit Work During the Relevant Time Period

Gately LLC issued audit reports for public company clients dated August 18, 2007, November 21, 2007, and December 6, 2007, and the clients included those audit reports in filings they submitted to the Securities and Exchange Commission. Gately LLC also issued 11 audit reports for public company clients between January 1, 2008 and April 4, 2008, including two audit reports dated January 24, 2008, an audit report dated January 30, 2008, two audit reports dated February 1, 2008, two audit reports dated February 20, 2008, and four audit reports dated February 25, 2008. Again, the clients included those reports in SEC filings. Two of the audit reports concerned the audit clients for which Inspections had requested engagement files as part of its effort to inspect Gately LLC.

In opposing summary disposition, Respondents asserted:

> As to any audits performed during this period by [Gately LLC], [Gately LLC] only accepted audits of non-active clients in which the financial statements were prepared by an external accountant who had prepared such statements for several years prior. . . . All information and back-up documentation with complete financial statements were provided by the external accountant to [Gately LLC]. The audits did not require that any information be kept by [Gately LLC] in storage after work was completed.

Further, "all of the information required in the audit could be provided at [Gately's] residence with a minimal amount of work on his part. None of the audit reports required traveling from the Miami area as did the PCAOB inspections process." The exception was an audit for "an active client" that "was conducted after [Gately] finished his rehabilitation." Gately "only conducted the 2008 audit of [the client] so the company would pay for him to visit the company's site in Africa, where he would be able to retrieve the company's 2006 [financial] information which had been requested by the PCAOB but had been destroyed in the fire."

D. Procedural History

The Board issued its Order Instituting Disciplinary Proceedings on April 4, 2008. On May 19, 2008, Respondents filed their Answer and Affirmative Defenses, in which they admitted nearly all of the factual allegations in the Order but denied that they violated Rule 4006, claiming as an affirmative defense that they

> cooperated with the PCAOB inspection process to the fullest extent possible under the circumstances. Lack of cooperation implies intentional or reckless disregard of one's responsibilities. Such an allegation is inapplicable when performance is not negligently disregarded but made impossible due to alcoholism, treatment thereof, and court mandated probation.

On July 1, 2008, Enforcement filed a Motion for Summary Disposition pursuant to Rule 5427. Respondents filed their opposition to the motion on September 3, 2008, and, on September 11, 2008, filed the Affidavit of Bradley P. Kerschensteiner as additional support. Noting that the affidavit was untimely and that Respondents had neither moved for leave to supplement their response nor offered any purported good cause for the untimely filing, the hearing officer disregarded it. The Initial Decision noted that "[i]n any event, the Affidavit merely provides details of Gately's treatment for alcoholism that are also set forth in Respondents' Verified Statement of Additional Material Facts and Response to PCAOB's Alleged Undisputed Facts and discussed [in the Initial Decision]."

On October 20, 2008, the hearing officer granted summary disposition in favor of Enforcement. As sanctions for the violations of Rule 4006, the hearing officer permanently revoked Gately LLC's registration with the Board and permanently barred Gately from association with a registered public accounting firm. Respondents timely petitioned for review of the Initial Decision pursuant to Rule 5460.

III.

A. Summary Disposition Standard

Rule 5427 provides that "[t]he hearing officer shall promptly grant a motion for summary disposition if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a disposition as a matter of law." This case presents the first application of this rule, which, in substance, parallels Rule 56 of the Federal Rules of Civil Procedure, as well as Rule 250 of the SEC Rules of Practice. Under these provisions, the ultimate question is whether the record as a whole demonstrates the existence of any factual disputes that must be resolved through a hearing. "[A] party seeking summary judgment [must] make a preliminary showing that no genuine issue of material fact exists. Once the movant has made this showing, the nonmovant must contradict the showing by pointing to specific facts demonstrating that there is, indeed, a trialworthy issue."[4/]

To preclude summary disposition, any unresolved factual issues must be both genuine and material—"the mere existence of some alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no genuine issue of material fact."[5/] In considering a motion for summary disposition, the record will be viewed most favorably to the non-moving party, but "we need not credit purely conclusory allegations, indulge in rank speculation, or draw improbable inferences."[6/] "Where the record taken as a whole could not lead a rational trier of fact to find for the nonmoving party, there is no 'genuine issue for trial.'"[7/] Finally, in a non-jury proceeding such as this, it may be appropriate, in

[4/] National Amusements, Inc. v. Town of Dedham, 43 F.3d 731, 735 (1st Cir. 1995).

[5/] Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247-48 (1986) (emphasis in original).

[6/] National Amusements, 43 F.3d at 735.

[7/] Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986) (quoting Fed. R. Civ. P. 56(e)).

evaluating the entire record, to draw inferences from undisputed facts so long as those inferences do not depend on the evaluation of witness credibility.[8]

B. Summary Disposition was Appropriate as to Respondents' Failure to Cooperate

Captioned "Duty to Cooperate with Inspectors," Rule 4006 provides:

> Every registered public accounting firm, and every associated person of a registered public accounting firm, shall cooperate with the Board in the performance of any Board inspection. Cooperation shall include, but is not limited to, cooperating and complying with any request, made in furtherance of the Board's authority and responsibilities under the Act, to –
>
> (a) provide access to, and the ability to copy, any record in the possession, custody, or control of such firm or person, and
>
> (b) provide information by oral interviews, written responses, or otherwise.

Thus, both Gately LLC and Gately were required to cooperate with Inspections in its effort to conduct an inspection of Gately LLC.

Inspections began its efforts to conduct an inspection of Gately LLC in early 2007. It is unclear, however, whether Gately received the February 2007 voice mails left by Inspections staff, and, by the time of Inspections' May and June 2007 communications, Gately was undergoing in-patient treatment for alcoholism. Acknowledging this, after initially attempting to schedule the inspection field work on August 13, 2007, Inspections postponed the inspection until October 1, 2007 to accommodate Gately's treatment. Similarly, in September 2007, Inspections postponed the inspection and rescheduled it for November 5, 2007, in response to Gately's representation that he needed time to retrieve his files from storage. Respondents

[8] See Ramallo v. Reno, 931 F. Supp. 884, 888 (D.D.C. 1996); see also Fox v. Johnson & Wimsatt, Inc., 127 F.2d 729, 737 (D.C. Cir. 1942) ("Conflict concerning the ultimate and decisive conclusion to be drawn from undisputed facts does not prevent rendition of a summary judgment, when that conclusion is one to be drawn by the court.").

cannot be found to have failed to cooperate where Inspections agreed to these postponements based on truthful representations from Gately.

Instead, Respondents' lack of cooperation began with their failure to complete and submit the IIF that Inspections sent Gately on September 12, 2007. The IIF required Respondents to provide a range of information regarding Gately LLC's public company audit clients—from their names, locations, and industries to the release date of the audit reports Gately LLC had issued for each client—all of which was highly relevant to the inspections process. Inspections set an initial deadline of September 20, 2007 for Respondents to complete and submit the IIF. Respondents missed that deadline, as well as later deadlines set by Inspections for submission of the IIF, and had not submitted the IIF when disciplinary proceedings were instituted on April 4, 2008.[9/]

When Respondents failed to submit a completed IIF, Inspections identified two known Gately LLC audit clients for review, and asked for the audit engagement files. Once again, Inspections set several deadlines for Respondents to produce or submit those files, but Respondents missed every deadline, had not produced the engagement files as of the time disciplinary proceedings were instituted, and, as far as the record shows, have not submitted engagement files any time thereafter.[10/]

On November 29, 2007, Inspections sent Respondents a Data Request form seeking information regarding Gately LLC, and set a deadline of December 7 for Respondents to complete and submit the Data Request form. Respondents missed that deadline, as well as the December 28 deadline subsequently set by Inspections, had not submitted the Data Request form as of the time disciplinary proceedings were instituted, and, as far as the record shows, have not submitted the Data Request form any time thereafter.

[9/] On August 15, 2008—eleven months after it was requested and four months after this proceeding was instituted—Respondents provided Inspections with the IIF.

[10/] In their reply brief before the Board, Respondents assert that on June 5, 2008 they "received a communication from PCAOB Inspections stating that the PCAOB would now be choosing new audit files as opposed to those originally selected for Inspection." For purposes of our decision, we need not consider whether the original request for the audit files was superseded on June 5, 2008. The relevant point is that Respondents never complied with the request described here, which was one of the grounds for instituting disciplinary proceedings on April 4, 2008.

Respondents assert that cooperation was made impossible by Gately's physical and mental impairment due to alcoholism and his treatment for that condition. They concede in their brief on appeal that "[w]hen viewed in a vacuum, Gately did not comply with Inspections demands," but argue that summary disposition was inappropriate because there was a genuine issue of material fact "as to the Respondent's mental abilities and capabilities during the very time in which the [hearing officer] unilaterally concludes that the Respondent had no impediment to cooperation." For the reasons described below, however, we find that Respondents have not demonstrated a genuine issue of fact about whether Gately was so incapacitated throughout the period in question as to be unable to provide any of the requested information.[11/]

Inspections' efforts to obtain information needed to conduct an inspection of Gately LLC can be divided into two stages for purposes of considering Respondents' capacity to cooperate. The first stage runs from September 12, 2007, when Inspections sent the IIF to Respondents, through the end of 2007.[12/] Respondents contend that during this period Gately's ability to cooperate in the inspection was constrained by his treatment, the restrictions on his travel, and his loss of certain files in a fire. But while these circumstances may have made it more difficult for Respondents to cooperate with Inspections, the evidence does not demonstrate a genuine issue of fact about whether Respondents were incapable of any cooperation. The record establishes beyond dispute that, during this stage, Inspections persisted in its efforts to obtain information from Respondents in order to conduct its inspection of Gately LLC. Respondents, however, failed to provide any of the requested information.

[11/] If we were to determine otherwise—that there was a genuine issue concerning Respondents' capacity to comply—we would then need to determine whether that issue was material to the question of the existence of a Rule 4006 violation and, even if not material to that question, separately assess whether that issue was material to the appropriateness of the sanctions imposed. Because we find there is no genuine issue concerning capacity, we do not address those materiality questions.

[12/] Prior to that time, from April 25 through July 19, 2007, Gately was undergoing in-patient treatment for alcoholism. We have no need to consider whether this rendered Respondents incapable of providing any of the requested information because, as explained above, Respondents cannot be found to have failed to cooperate during a period in which Inspections agreed to postponements based on truthful representations from Gately.

First, Respondents failed to complete and return the IIF, which sought information about Gately LLC's audit clients. To attempt to justify this failure, Respondents say they needed information from files that were stored in Orlando, and that Gately traveled there twice to obtain files. The first time, in August 2007, he relapsed, was arrested, and did not succeed in obtaining any files; the second time, in November 2007, he did obtain files, some of which were later destroyed in a fire. Viewed in the light most favorable to Respondents, this may have made it difficult or even impossible to complete the IIF in full. It is not, however, evidence that Respondents were prevented from providing all of the information requested in the IIF. On the contrary, it is undisputed that Gately LLC issued one audit opinion in August, another in November, and a third in December, 2007; Respondents have offered no justification for their prolonged failure to complete the IIF at least as to those clients.

Second, Respondents provided none of the audit engagement files Inspections requested. Respondents rely on the fact that some of the files for the two engagements selected by Inspections were lost in a fire, but they do not contend that all the files were lost, and they were required at least to provide whatever files remained.

Third, Respondents failed to complete and submit the Data Request form, which requested information about Gately LLC and its operations and staff. Respondents have offered no evidence that they were unable to provide any of the information requested in the Data Request, including a list of "individuals who manage the Firm, an indication of their primary responsibilities, and their biographies," "all [the Firm's] affiliation arrangements," "[s]upport for the Firm's legal name (e.g., partnership agreement, shareholders' agreement)," and the Firm's practice areas.

On appeal, Respondents argue that the hearing officer erred by excluding the affidavit of Bradley P. Kerschensteiner, a therapist who participated in the treatment of Mr. Gately during 2007. The Kerschensteiner affidavit, they assert, would have established a genuine issue of material fact about Gately's state of mind and ability to perform. As described above, although the hearing officer stated that the affidavit would be disregarded, he noted in the Initial Decision that "[i]n any event, the Affidavit merely provides details of Gately's treatment for alcoholism that are also set forth in Respondents' Verified Statement of Additional Material Facts and Response to PCAOB's Alleged Undisputed Facts and discussed [in the Initial Decision]."

The Kerschensteiner affidavit describes Gately's treatment and concludes that Gately suffered from chemical dependence, post-traumatic stress disorder, and depression throughout 2007, resulting "in a general inability to function in otherwise normal business circumstances, an inability to maintain focus, and an avoidance pattern when presented with stressful circumstances." Viewed in the light most favorable to Respondents, the affidavit does not demonstrate that there is a genuine issue of fact about Gately's capacity to cooperate with Inspections. During this period, Respondents provided none of the information Inspections requested. At the same time, Gately LLC issued two audit opinions—one in November and one in December 2007.[13/] If it was possible for Gately LLC to opine on the financial statements of public companies, no rational finder of fact could find that Respondents were incapable of providing at least some of the requested information.

The second stage of Inspections' efforts to obtain information began with Inspections' letter to Respondents on January 3, 2008, in response to Gately's January 2, 2008 email. In the letter, which was attached to an email sent to Gately, Inspections refused to set yet another deadline for Respondents to provide the information Inspections had requested, but clearly explained that Inspections' "demand for the requested materials . . . still stands . . . ." In a subsequent email on January 4, 2008, Gately acknowledged that he was able to open the letter. Nevertheless, Respondents have offered no representation or evidence that they made any effort to comply with Inspections' requests between January 3, 2008 and well after the date this proceeding was instituted.[14/]

In opposing summary disposition, Gately asserted that after receiving Inspections' January 3, 2008 letter, he "understood that [the] matter would further be handled by the PCAOB's enforcement division given that the deadline of December 28 had already [passed]." In light of the clear statement in Inspections' January 3 letter that that the demand for the information "still stands," this is not a tenable excuse for Respondents' failure to cooperate.

Moreover, Respondents' own actions preclude any claim that Gately was so incapacitated during this stage that Respondents could provide none of the requested information. According to Respondents, Gately was so fully recovered as of February 2008 that he moved out of the "three-quarters way" house in which he had been living,

[13/] Gately LLC also issued an audit opinion in August 2007.

[14/] We need not decide for purposes of this opinion whether any of Inspections' pending requests were superseded on June 5, 2008. See supra Note 10.

and, by the end of February, Gately LLC had issued 11 audit reports in 2008, one of which apparently required a trip to Africa.[15]

Therefore, even viewing the record most favorably to Respondents, there is an absence of evidence to support Respondents' claim that Gately was so incapacitated as to be unable to cooperate with the inspection of Gately LLC. As a result, based on undisputed facts, no rational finder of fact could find in Respondents' favor on the issue of their liability. Accordingly, summary disposition is appropriate on that issue, and we find that Respondents violated Rule 4006.

C. Summary Disposition was Appropriate as to Sanctions

Section 105(c)(4) of the Act authorizes us to impose, subject to Section 105(c)(5), "such disciplinary or remedial sanctions as [the Board] determines appropriate," for violations of the rules of the Board. Section 105(c)(5) provides that if the violation resulted from intentional or knowing conduct, including reckless conduct, the sanctions we may impose include revocation of PCAOB registration and a bar from association with a registered public accounting firm.[16] The hearing officer found that based on the undisputed facts, any rational finder of fact would have to conclude that Respondents' failure to cooperate in violation of Rule 4006 was at least reckless.

Gately argues that the hearing officer erred by failing to treat the question of whether Respondents' violations resulted from intentional or knowing conduct, including reckless conduct, as a genuine issue of material fact that required a hearing. We disagree.

As described in detail above, Inspections repeatedly requested information and cooperation from Respondents over an extended period of time. When Respondents did not cooperate, Inspections warned them that noncompliance could result in disciplinary action. Gately has not argued, and could not reasonably argue, that he did not know that he was failing to provide Inspections with any of the information that they repeatedly requested. Indeed, Gately's email communications to Inspections demonstrate his awareness of Inspections' requests and warnings. Respondents,

[15] The Kerschensteiner affidavit does not address Gately's ability to cooperate in 2008.

[16] The Board may also impose these sanctions for repeated instances of negligent conduct, each resulting in a violation. Section 105(c)(5)(B).

however, provided none of the requested information until after the Board instituted this proceeding. During this period of noncompliance, and in the face of Inspections' warnings, Gately LLC issued 13 audit reports on issuers. Under these circumstances, even viewing the record most favorably to Respondents, their violations can only have resulted from conduct that was at least reckless, and they have failed to identify any issue in that regard that would require a hearing.[17]

Having determined that we may, consistent with the Act and the Board's rules, impose a revocation and bar does not alone answer the question of whether those sanctions are appropriate for the violations in this case. We separately address that issue here.

Respondents argue that these sanctions are too severe. They note that there has been no allegation that they engaged in fraud or deceit and conclude that their conduct was less culpable than the conduct of other respondents in other Board actions who received more lenient sanctions. Respondents argue that Gately is, "at worst, an alcoholic who suffered through a debilitating and actually life-threatening condition that he readily admits impaired and impeded his ability to engage in normal business and professional discourse."

This argument misapprehends the threat to the system of Board oversight posed by noncooperation with PCAOB inspections. Under the Act, the Board must periodically inspect any registered firm that, like Gately LLC, regularly issues audit reports for public companies.[18] These inspections are fundamental to the Board's ability to "oversee the audit of public companies that are subject to the securities laws . . . in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. . . ."[19] In order to obtain the information

[17] Respondents argue that the Kerschensteiner affidavit demonstrates a genuine issue of material fact about Gately's state of mind. But even if Gately demonstrated "an avoidance pattern when presented with stressful circumstances" throughout 2007, any rational finder of fact would have to conclude, based on the record taken as a whole, that Respondents' violations of Rule 4006 resulted from conduct that was at least reckless. And in any event, as discussed above, Respondents' failure to cooperate continued well into 2008.

[18] Section 104(b)(1) of the Act.

[19] Section 101 of the Act.

necessary to conduct the required inspections, the Board must depend on—and requires—the full cooperation of registered firms and associated persons thereof. Failure to cooperate with an inspection frustrates the oversight system put in place by the Act and, in turn, threatens the public interest by impeding the Board's ability to detect violative conduct.[20/] The absence of fraud or deceit does not, therefore, diminish the seriousness of Respondents' failure to cooperate in an inspection designed, among other things, to uncover any such misconduct.

Respondents also argue that, contrary to the hearing officer's findings, there was evidence "tending to show that Respondent cooperated with the inspection to the extent possible in 2008." Specifically, Respondents note, for the first time in their reply brief on appeal, that they provided Inspections with the IIF on August 15, 2008 and that Inspections acknowledged receipt on August 18, 2008. Respondents also state that on June 5, 2008, two days after a pre-hearing conference in which they claim that the hearing officer "indicated that Respondents completion of the inspections process would likely be a mitigating factor in the pending dispute," Inspections notified Respondents that "it would now be choosing new audit files as opposed to those originally selected for inspection."[21/] According to Respondents, "[t]his decision ensured that no

[20/] Congress recognized that cooperation with the Board by registered public accounting firms and their associated persons was critical to the system of oversight it put in place in Title I of the Act. Under Section 102(b)(3), a public accounting firm's application for registration with the Board is required to contain, among other things:

> a consent . . . to cooperation in and compliance with any request for testimony or the production of documents made by the Board in furtherance of its authority and responsibilities under this title (and an agreement to secure and enforce similar consents from each of the [firm’s] associated persons . . . as a condition of their continued employment by or other association with such firm); and (B) a statement that such firm understands and agrees that cooperation and compliance . . . shall be a condition to the continuing effectiveness of the registration of the firm with the Board.

[21/] Respondents attached letters evidencing the submission and receipt of the IIF to their reply brief, as well as the fact that Inspections asked Respondents for more current information.

compliance would be effectuated before the PCAOB's Motion for Summary Disposition was decided."[22/]

While it appears that the hearing officer was unaware of these facts, and he did not consider them, they do not alter our conclusion that Respondents failed to cooperate in any manner with the inspection or mitigate that failure.[23/] The Board instituted this proceeding after Respondents failed for more than six months to provide any of the information requested by Inspections despite repeated requests for compliance. That Respondents provided the IIF after the proceeding was instituted does not convert their complete failure to cooperate into partial cooperation or demonstrate that they cooperated to "to the extent possible."[24/] Accordingly, we do not credit Respondents' provision of the IIF months after disciplinary proceedings against them were instituted.[25/]

[22/] According to the reply brief, "Respondent finds this occurrence conspicuous." We are unaware of facts suggesting that Inspections altered its document requests in an attempt to influence this proceeding, and Inspections' August 18 letter to Respondents, attached to Respondents' reply brief, explicitly disclaims such an effort. Rather, that letter explains that as a result of Respondents' noncompliance, Inspections was unable to conduct an inspection of Gately LLC in 2007 and hoped instead to conduct an inspection of Gately's more recent audit engagements.

[23/] As a result, we deny Enforcement's Motion for Leave to File Sur-Reply Brief in response, and Respondents' Motion to Strike Enforcement's Motion is moot.

[24/] Cf. CMG Institutional Trading, Exchange Act Rel. No. 59325, 2009 SEC LEXIS 215, at *20 (Jan. 30, 2009) ("we have emphasized repeatedly that NASD should not have to initiate a disciplinary action to elicit a response to its information requests made pursuant to Rule 8210"); Paz Securities, Exchange Act Rel. No. 57656, 2008 SEC LEXIS 820, at *16 (Apr. 11, 2008) ("failure to respond until after NASD barred Applicants is not merely a 'slow' response; such a failure is tantamount to a complete failure to respond").

[25/] We disagree with Respondents' characterization of the hearing officer's remarks at the pre-hearing conference regarding mitigation. According to the transcript, the hearing officer noted that in adjudicating cases for the Financial Industry Regulatory Authority ("FINRA"), he considered relevant whether: (1) the Respondent made a good faith effort to respond, even if he or she could not produce everything requested, and (2) the Respondent ever provided the information, even if he or she did so late. On the second point, the hearing officer said, "So, generally speaking, depending on how far

We have found that Respondents failed to cooperate with a Board inspection for a prolonged period of time and despite repeated warnings that noncooperation could result in a disciplinary proceeding. As a result, the Board has been unable to assess Respondents' compliance with applicable requirements in their conduct of audits. Respondents' actions were egregious—during the period of noncooperation, Gately LLC issued 13 audit reports. As discussed above, that fact fatally undermines Respondents' only proffered explanation for their failure to cooperate—that Gately was rendered so incapacitated by alcoholism and related personal circumstances that Respondents could not provide any of the information Inspections requested. We have found that Respondents' violations resulted from conduct that was at least reckless, and that there are no factors that mitigate Respondents' failure to cooperate. Finally, if Gately LLC continues to issue audit reports for public companies, Respondents will have opportunities for future violations because Gately LLC will again be subject to inspection.

Under the circumstances of this case, there exists too great a risk to investors to allow Respondents to continue to engage in audits of issuers. It is therefore in the public interest to permanently revoke the registration of Gately LLC and to permanently bar Gately from associating with any registered accounting firm.

An appropriate order will issue.[26/]

By the Board.

down the road it is you may get some credit for doing it late even if it is late even if that is not a complete defense." These are general statements about the hearing officer's view of the law in FINRA cases, rather than about the particular facts of the "pending dispute." Moreover, these statements are not inconsistent with our finding that the Respondents' provision of the IIF was too late in the process— i.e., too "far down the road"— to credit.

[26/] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

PCAOB
Public Company Accounting Oversight Board

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Gately & Associates,
LLC and James P. Gately, CPA,

Respondents.

PCAOB File No. 105-2008-001

June 4, 2009

ORDER IMPOSING SANCTIONS

On the basis of the Board's opinion issued this day it is

ORDERED that James P. Gately is permanently barred from associating with any registered public accounting firm, effective upon the expiration of the time period for filing an application for review of this determination with the Securities and Exchange Commission, or, if such an application is filed, upon the lifting of the stay imposed pursuant to Section 105(e) of the Sarbanes-Oxley Act of 2002; and it is further

ORDERED that Gately & Associates, LLC's registration with the Board is permanently revoked, effective upon the expiration of the time period for filing an application for review of this determination with the Securities and Exchange Commission, or, if such an application is filed, upon the lifting of the stay imposed pursuant to Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board

J. Gordon Seymour
Secretary

June 4, 2009

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of
Larry O'Donnell, CPA, P.C. and
Larry O'Donnell, CPA

Respondents.

PCAOB File No. 105-2010-002

FINAL DECISION

October 19, 2010

Appearances

Bernard A. McDonough, Esq., Washington, DC, for the Division of Enforcement and Investigations.

Ordered for Review on Board's Initiative: June 10, 2010
Last brief received: July 1, 2010

I.

On review of the Hearing Officer's initial decision, we find, as the Hearing Officer did, that Larry O'Donnell, CPA, P.C., ("the Firm") a registered public accounting firm, and Larry O'Donnell, CPA ("O'Donnell") (collectively, "Respondents") engaged in conduct constituting noncooperation with an investigation. Because of that conduct, we permanently revoke the Firm's registration, we permanently bar O'Donnell from being an associated person of a registered public accounting firm, and we impose a civil money penalty of $75,000 on O'Donnell.

Respondents were served with the Board's Order Instituting Disciplinary Proceedings ("OIP") alleging noncooperation with an investigation, but they did not file an answer as required by the OIP or otherwise file any papers or appear in the proceeding. The Hearing Officer issued a default decision taking as true the allegations in the OIP[1] and also taking account of evidence submitted by the Division of Enforcement and Investigations ("the Division") in a Motion for Entry of a Default Decision, which includes evidence supporting the allegations in the OIP. Our decision is based on a de novo review of the record, also taking as true the allegations of the OIP and taking account of the evidence submitted by the Division.

II.

The Firm is a public accounting firm located in Aurora, Colorado, organized as a professional corporation under Colorado law, and licensed by the Colorado Board of Accountancy. The Firm is registered with the PCAOB pursuant to Section 102 of the Sarbanes-Oxley Act of 2002 (the "Act") and PCAOB Rules. O'Donnell is a certified public accountant licensed in Colorado. At all relevant times, O'Donnell was the Firm's president, sole principal, and only audit staff. O'Donnell is, and at all relevant times was, an associated person of a registered public accounting firm as defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i).

On July 28, 2009, the Board issued an Order of Formal Investigation (OFI) pursuant to PCAOB Rule 5101(a)(1). The OFI stated that the Board had received information indicating that the Firm and one or more of its associated persons may have violated PCAOB Rules 3100 and 3200T by failing to comply with certain PCAOB standards in auditing and reviewing the financial statements of four companies specified in the OFI. The OFI authorized an investigation to determine whether the Firm or any associated person of the Firm had engaged in the specified acts or practices or in acts or practices of similar purport or object. The OFI authorized the Division to issue Accounting Board Demands ("ABDs") for documents and testimony relevant to the matters described in the OFI.

[1] PCAOB Rule 5409(a) provides that "[a] party may be deemed to be in default and the Board or the hearing officer may determine the proceeding against that party upon consideration of the record, including the order instituting proceedings or notice of hearing, the allegations of which may be deemed to be true, if that party fails . . . to answer when required to do so by a Board order . . . ."

A. The ABDs Related to Scharfman

Pursuant to the OFI, the Division issued an ABD requiring O'Donnell to provide testimony in the investigation. In testimony on December 8 and 10, 2009, O'Donnell provided information indicating the possibility that Lawrence Scharfman had become an associated person of the Firm. That information was potentially significant because, on August 11, 2009, the Board had permanently barred Scharfman from being an associated person of any registered public accounting firm.[2] It would be a violation of the Act and PCAOB Rules for the Firm to permit Scharfman's association without the consent of the Board or the Securities and Exchange Commission ("Commission") if the Firm knew, or in the exercise of reasonable care should have known, of the bar.[3] It would also be a violation of PCAOB Rules for O'Donnell to engage in conduct that he knew, or was reckless in not knowing, would substantially contribute to such a violation by the Firm.[4]

The possibility of such violations was indicated by O'Donnell's testimony about an agreement through which he was acquiring Scharfman's public company auditing practice. O'Donnell testified that the agreement involved paying Scharfman "roughly half" of the audit fees the Firm received from each of Scharfman's former audit clients for "a period of time" that O'Donnell thought was four years. O'Donnell also testified that he understood that the reason Scharfman was no longer performing audits for those clients was that Scharfman "went through a similar procedure like this," and that the outcome was that "he's no longer registered with the PCAOB."

O'Donnell testified that his agreement with Scharfman was documented, that he had issued audit opinions on some of the issuer audit clients acquired from Scharfman, and that he had already made "most likely about half a dozen" payments to Scharfman pursuant to the agreement, ranging from $2,000 to $15,000.[5] During O'Donnell's

[2] See Lawrence Scharfman CPA PA, PCAOB Rel. No. 105-2009-005 (August 11, 2009).

[3] See Section 105(c)(7)(A) of the Act and PCAOB Rule 5301(b).

[4] See PCAOB Rule 3502.

[5] O'Donnell testified that Scharfman did not consult with O'Donnell on the performance of the audits but "may talk about the fee arrangements because he has a vested interest in it." Even assuming for present purposes that Scharfman did not consult on the audits, the arrangement between O'Donnell and Scharfman may

testimony on December 10, 2009, Division staff told O'Donnell that they would issue an ABD requiring production of "the agreement [with Scharfman], including any addendums and attachments to that agreement, and copies of any checks that were issued to him and invoices relating to the engagements covered by that agreement." In response to the Division staff asking how hard it would be for O'Donnell "to put your hands on" those documents, O'Donnell answered that "The Scharfman agreements are in the administrative file. Most of those are not difficult." Division staff told O'Donnell that they would require production of the documents by December 18, 2009, and O'Donnell responded "Okay."

On December 14, 2009, the Division issued separate ABDs to the Firm and O'Donnell (the "December 14 ABDs"), each requiring production by December 18, 2009 of, among other things, "all documents relating or referring to Lawrence Scharfman CPA PA and/or Lawrence Scharfman CPA (together, "Scharfman"), including but not limited to: communications with Scharfman . . . ; agreements (including attachments, addenda, and modifications thereto); invoices or other bills; evidences of payment . . . and documents identifying any Scharfman clients who have become clients of the Firm." The December 18 deadline passed without Respondents producing the documents, requesting an extension of the deadline, or otherwise responding. On December 29, 2009, the Division sent Respondents a letter reminding them that production was overdue and demanding production immediately. Respondents did not respond to the December 29 letter.

On January 22, 2010, the Division sent Respondents a letter describing the Division's intention, based on the failure to respond to the December 14 ABDs, to recommend that the Board commence a disciplinary proceeding alleging noncooperation with the investigation. Pursuant to PCAOB Rule 5109(d), that letter offered Respondents an opportunity to submit a written statement of position regarding whether a disciplinary proceeding should be instituted, and gave them until February 5, 2010 to do so. The January 22 letter, like each previous transmittal of an ABD to Respondents, informed Respondents that Board disciplinary action for noncooperation with an investigation could result in sanctions including revocation of the firm's

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nevertheless have made Scharfman an associated person of the Firm in violation of the bar. As defined in the Act and PCAOB Rules, an individual may be a person associated with a registered public accounting firm solely by virtue of "shar[ing] in the profits of, or receiv[ing] compensation in any other form from, that firm" in connection with the firm's preparation or issuance of any audit report." Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i). In this proceeding, the Division has not alleged that, and we do not reach the question of whether, Scharfman became an associated person of the Firm.

registration, a bar on association with registered firms, and other lesser sanctions. Respondents never responded to the January 22 letter and never produced the documents required by the December 14 ABDs.

B. Procedural History

The Board issued an OIP against Respondents on March 29, 2010. The OIP alleged that Respondents' conduct in connection with the December 14 ABDs constituted noncooperation with an investigation. The OIP required Respondents to file an answer to the allegations within 20 days after service of the OIP.

The OIP was served on Respondents on April 1, 2010. Respondents did not file an answer or otherwise respond to the OIP within the 20 days prescribed by the OIP. On April 26, 2010, the Hearing Officer issued an order holding Respondents in default, but also giving Respondents until May 7, 2010 to file any motion, pursuant to PCAOB Rule 5409(b), to set aside the default. The April 26 order provided that if Respondents did not file a timely motion to set aside the default, the Division could file a motion seeking a default decision.

Respondents did not file a motion to set aside the default. On May 12, 2010, the Division filed a Motion for Entry of a Default Decision and submitted with the motion an appendix of documents offered as evidence of allegations in the OIP and of other matters. On May 19, 2010, the Hearing Officer issued an initial decision granting the Division's motion. The Hearing Officer found that each Respondent had failed to cooperate with the investigation by failing to comply with the December 14 ABD directed to that Respondent. The Hearing Officer concluded that those failures warranted revocation of the Firm's registration, a bar on O'Donnell's association with a registered public accounting firm, and a $25,000 civil money penalty against each Respondent.

No party filed a petition for Board review of the initial decision. On June 10, 2010, the Board ordered review of the initial decision on its own initiative, pursuant to PCAOB Rule 5460(b). The June 10 Order permitted the parties to file briefs by specified deadlines. The Division filed a timely brief on July 1, 2010. That same date, the Division filed a Motion to Adduce Additional Evidence pursuant to PCAOB Rule 5464. The Division filed a second Motion to Adduce Additional Evidence on September 21, 2010. Respondents did not file a brief, respond to either of the Division's motions to adduce additional evidence, or otherwise appear in this review proceeding before the Board.

III.

Section 105(b)(3) of the Act, captioned "Noncooperation with Investigations," authorizes the Board to impose sanctions if a registered firm or associated person "refuses to testify, produce documents, or otherwise cooperate with the Board in connection with an investigation." PCAOB Rule 5300(b) similarly provides for sanctions if such a firm or person "has failed to comply with an accounting board demand, has given false testimony or has otherwise failed to cooperate in an investigation."

In this case, the uncontroverted evidence in the record establishes that Respondents failed to respond in any manner to the December 14 ABDs. They did not produce responsive documents, did not attempt to explain their failure or seek additional time, and did not assert any objection to the Division's authority to require production of the documents described in the December 14 ABDs. Respondents' failure to provide any such response continued despite the Division's follow up letter of December 29, 2009; the Division's January 22, 2010 letter pursuant to Rule 5109(d); and notice of the institution of disciplinary proceedings served on them on April 1, 2010. On these facts, we conclude that each Respondent's failure to respond to the December 14 ABDs constitutes noncooperation for which we may impose sanctions.

IV.

For noncooperation with an investigation, the Board is authorized to revoke or suspend a firm's registration, to bar or suspend an individual from association with any registered public accounting firm, or to impose certain lesser sanctions as the Board considers appropriate and as specified by rule of the Board.[6/] We have concluded that the appropriate sanctions for Respondents' failures to respond to the December 14 ABDs are revocation of the Firm's registration, a bar against O'Donnell being associated with any registered public accounting firm, and a $75,000 civil money penalty against O'Donnell.

[6/] See Section 105(b)(3) of the Act and PCAOB Rule 5300(b). Rule 5300(b) specifies, by incorporating certain provisions of Rule 5300(a), that those lesser sanctions may include civil money penalties.

A. Revocation and Bar

The Board's power to investigate possible violations and to impose appropriate sanctions[7/] is fundamental to its ability to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[8/] Conducting investigations in an appropriate and timely manner depends upon registered firms' and associated persons' compliance with demands for documents and testimony made pursuant to the Board's authority under the Act. Noncooperation frustrates the oversight system by impeding the Board's ability to determine whether violations have occurred for which sanctions should be imposed, including sanctions that would protect investors from further violations, and thus deprives investors of an important protection that the Act was intended to provide.[9/]

We find that Respondents' conduct warrants revocation of the Firm's registration and a bar on O'Donnell's association with any registered public accounting firm. Respondents' noncooperation prevented the Board from being able to follow up adequately on indications of possible violations of law and PCAOB Rules – specifically, the possible circumvention of a previous Board disciplinary order barring an individual from association with any registered firm because of that person's misconduct. Despite ample opportunity to respond to the document demands, Respondents have never done so and never suggested any possible mitigating circumstance relating to their failure. This type of noncooperation undermines the Board's ability to protect investors and advance the public interest, and indicates a lack of sufficient regard for Board processes and authority designed to do so.[10/] If the Firm were to remain a registered firm and

[7/] See Sections 101(c)(4), 105(b)(1), and 105(c)(4) of the Act.

[8/] Section 101(a) of the Act.

[9/] Cf. Gately & Associates, LLC, SEC Release No. 34-62656 at 22-23, 2010 WL 3071900 at *15 (August 5, 2010) (recognizing seriousness of failure to cooperate in PCAOB inspection designed, among other things, to uncover misconduct).

[10/] Cf. Paz Securities, Inc., SEC Release No. 34-57656 at 6, 2008 WL 1697153 at *4 (Apr. 11, 2008) (NASD "members and their associated persons who fail to respond in any manner to [NASD information requests under Rule 8210] should be barred (or expelled) unless there are mitigating factors sufficient to rebut the presumption that such violators present too great a risk to the markets and investors to be permitted to remain in the securities industry.").

O'Donnell an associated person, they would have opportunities to similarly undermine those processes, and thereby jeopardize investor protection, in the future.[11/]

B. Civil Money Penalty

We also find that Respondents' conduct warrants the imposition of a civil money penalty. Section 105(c)(4) of the Act authorizes the Board to impose such "disciplinary or remedial sanctions as it determines appropriate" for violations of certain laws, rules, and standards, and specifies that those sanctions may include civil money penalties up

[11/] The record includes evidence of a state disciplinary history that provides additional reason to believe that Respondents pose such a risk. Exhibits to the Division's Motion for Entry of a Default Decision include a July 28, 2000 Final Agency Order of the Colorado State Board of Accountancy ("Colorado Board") imposing a $2,000 fine on O'Donnell for failing to comply with state law requirements to register his firm with the Colorado Board every three years, even though he had been under a previous Colorado Board order, arising out of a previous failure, to comply with that requirement. In addition, the Division's September 21, 2010 Motion to Adduce Additional Evidence ("September 21 Motion") seeks to introduce evidence of a May 3, 2010 Colorado Board Stipulation and Final Agency Order imposing various restrictions and requirements because of O'Donnell's failure to comply with an earlier order requiring him to submit to concurring reviews, obtain prior approval of concurring reviewers, submit quarterly reports, and obtain certain continuing professional education, and his failure to respond to certain Colorado Board communications as required by state law. Because the Division has not supported inclusion of either of these documents with authentication by any Colorado official, we treat the Division's proffer of these documents as, in effect, a request that we take official notice of the information publicly available on the Colorado Board's web site. Given that Respondents have had an opportunity to dispute the information and have not done so, we do not hesitate to take notice of it, although we cite it here only as additional support for a conclusion that we would reach even in its absence. Cf. Joseph Ricupero, SEC Release No. 34-62891 at 11, 2010 WL 3523186 at *7-8 (September 10, 2010) (sustaining bar on individual's association with any National Association of Securities Dealer member because of individual's failure to respond to information requests, and noting that individual's prior disciplinary history is "further evidence" that individual posed risk to investing public should he re-enter securities industry). Accordingly, we grant the Division's September 21 Motion insofar as it relates to information from the Colorado Board's web site concerning, and including, the May 3, 2010 Stipulation and Final Agency Order.

to specified maximum amounts. Although that provision is separate from section 105(b)(3)'s provision authorizing sanctions for noncooperation with an investigation, section 105(b)(3) authorizes the Board to impose "such other lesser sanctions" (in addition to bars, revocations, and suspensions) as the Board specifies by rule, and the Board's rules implementing that authority incorporate, as such lesser sanctions, the civil money penalty provisions found in section 105(c)(4).[12/]

In considering whether a civil money penalty is an appropriate disciplinary or remedial sanction, we are guided by the statutorily prescribed objectives of any exercise of our sanctioning authority: the protection of investors and the public interest. See section 101(a) of the Act (Board established "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports"); section 101(c)(5) (Board to perform duties or functions as the Board determines necessary "to carry out this Act, in order to protect investors, or to further the public interest"). We are also cognizant that the Commission, in reviewing any contested sanctions that we impose, is called upon to do so with "due regard for the public interest and the protection of investors." Section 107(c)(3) of the Act.

For guidance, we also look to the factors enumerated in, and the Commission's application of, a somewhat comparable statutory authorization in the Securities Exchange Act of 1934 ("Exchange Act"). Like the authorization to the Board in the Act, section 21B of the Exchange Act authorizes the Commission to impose civil money penalties in administrative proceedings, up to specified maximum amounts, if the Commission finds that "such penalty is in the public interest."[13/] Unlike the Act, however, Exchange Act section 21B provides guidance regarding relevant factors "[i]n considering under this section whether a penalty is in the public interest."[14/] The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization

[12/] See PCAOB Rule 5300(b)(1) (incorporating sanctions described in Rule 5300(a)(4)).

[13/] Section 21B(a) of the Exchange Act.

[14/] Section 21B(c) of the Exchange Act.

("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.

Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered. See Next Financial Group, Inc. 93 SEC Docket 1369, 2008 WL 2444775 at *49 (June 18, 2008) (Initial Decision) ("Not all factors may be relevant in a given case, and the factors need not all carry equal weight"). The Commission has imposed civil money penalties under section 21B on numerous occasions, emphasizing various of these factors, including in cases in which the Commission imposed a bar in addition to the civil money penalty. See, e.g., VFinance Investments Inc., SEC Release No. 34-62448 at 27-28, 2010 WL 2674858 at * 18 (July 2, 2010) (barring individual from association with any broker or dealer in principal or supervisory capacity and imposing $30,000 civil money penalty described as "warranted to create a monetary incentive for Respondents and other industry participants to fulfill their recordkeeping obligations and cooperate with regulatory inquiries – particularly when, as in this case, such person is aware that compliance may reveal regulatory violations potentially resulting in disgorgement or monetary penalties"); Gregory O. Trautman, SEC Release No. 34-61167A at 42, 44, 2009 WL 4828994 at *22-23 (December 15, 2009) (barring individual from association with any broker or dealer and imposing a $120,000 civil money penalty as "necessary to deter others" from such conduct, and in light of fact that conduct involved deception causing harm to others and resulting in enrichment of individual's firm); Guy P. Riordan, SEC Release No. 34-61153 at 38-39, 2009 WL 4731397 at *21-22 (December 11, 2009) (barring individual from association with any broker or dealer and imposing separate $100,000 civil money penalties for each of five violations in light of fact that conduct involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement and resulted in substantial pecuniary gain); Joseph John VanCook, SEC Release No. 34-61039A at 31-32, 2009 WL 4005083 at *18 (November 20, 2009) (barring individual from association with any broker or dealer and imposing $100,000 civil money penalty described as "an amount necessary to deter VanCook from future misconduct" and that "will also have a remedial effect of deterring others from engaging in the same misconduct").[15/]

[15/] Trautman, Riordan, and VanCook all involved financial harm to investors that the Commission orders addressed through substantial disgorgement remedies (more than $600,000 in Trautman, more than $900,000 in Riordan, and more than $500,000 in VanCook), underscoring that the separate civil money penalty is imposed for a purpose distinct from making a financially harmed victim whole.

The courts have recognized that Commission sanctions involving bars and section 21B civil money penalties are appropriate, and should be upheld absent a "gross abuse of discretion," given that "Congress has charged the Commission with protecting the investing public," and the question of appropriate remedies is "peculiarly a matter for administrative competence." Rizek v. SEC, 215 F.3d 157, 160 (1st Cir. 2000) (upholding bar on individual's association with any broker, dealer, member of a national securities exchange, or member of a registered securities association and imposition of $100,000 civil money penalty) (quoting A.J. White & Co. v. SEC, 556 F.2d 619, 624 (1st Cir. 1977), and Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 185 (1973)).

The Board, too, is charged to exercise its sanctioning authority "as the Board considers appropriate"[16/] (subject to Commission review) to protect the investing public. Looking to the Exchange Act section 21B factors and precedent for guidance on protecting investors and advancing the public interest through civil money penalties,[17/] we conclude that a civil money penalty is plainly appropriate in this case.

In response to the December 14 ABDs, Respondents disregarded their obligation to cooperate with the Board's investigation. On the record, as described above, it is clear that this disregard was deliberate or reckless. Respondents produced none of the demanded documents and provided no response concerning the demanded documents even after receiving follow-up demands, warnings about disciplinary action, and notice of the institution of disciplinary proceedings.

We also conclude that Respondents' conduct caused at least indirect harm to others. Investors and markets are put at risk, and perhaps harmed in ways that never become known, when a regulatory investigation is improperly thwarted by a regulated person's refusal to provide information. Such noncooperation undermines the Board's

[16/] Section 105(b)(3)(A)(iii) of the Act; see also Section 105(c)(4) of the Act ("Board may impose such disciplinary or remedial sanctions as it determines appropriate").

[17/] Relevant, and similar, guidance is also provided by the courts even outside of the section 21B context. See McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005) (factors relevant in deciding whether a sanction is appropriately remedial include "the seriousness of the offense, the corresponding harm to the trading public, the potential gain to the [offender] for disobeying the rules, the potential for repetition in light of the current regulatory and enforcement regime, and the deterrent value to the [offender] and others").

ability to protect investors and advance the public interest by identifying and addressing misconduct in connection with the audits of public companies' financial statements. The undermining of this protection is a harm to investors and markets that factors into a sanctions analysis. Cf. Gately, SEC Release No. 34-62656 at 19, 2010 WL 3071900 at *13 (recognizing as obvious the risk to investors and markets posed by a failure to produce information in a Board inspection).

We have also considered together the section 21B factors concerning whether any person was unjustly enriched and whether there is a need to deter such person and other persons from similar noncooperation. The obligation of registered firms and associated persons to cooperate with the Board is a fundamental aspect of PCAOB registration status.[18/] Yet, under the processes set out in the Act and the Board's rules, it necessarily takes some time before Board disciplinary sanctions in response to noncooperation are imposed and take effect. During that time, nothing prevents the firm or person from continuing to reap financial benefits from performing audit services for issuers, all the while ignoring the corresponding cooperation obligation that is essential to the Board's ability to protect investors in those issuers.

In short, in the absence of a civil money penalty, noncooperation with the Board might seem to certain kinds of individuals – who fear that cooperation will provide information that would lead to sanctions for violations of laws, rules, or standards – to be the course most likely to prolong the period of their registration and allow them to maximize their income from issuer audit work before being sanctioned. A civil money penalty for noncooperation is appropriate both as a deterrent to that kind of reasoning and conduct, see VFinance Investments, Inc., SEC Release No. 34-62448 at 27-28, 2010 WL 2674858 at * 18 (civil money penalty warranted to create incentive for respondents and other industry participants to cooperate with regulatory inquiries, particularly when aware that compliance may reveal regulatory violations potentially resulting in disgorgement or monetary penalties), and, where applicable, to take

[18/] Section 105(b)(3) is only one of the statutory provisions reflecting the importance of such cooperation. See also section 102(b)(3) of the Act (requiring registration applicants to consent to cooperate with Board requests for testimony and production of documents, to agree to secure and enforce similar consents from their associated persons, and to acknowledge and agree that such cooperation is a condition to the continuing effectiveness of the firm's registration with the Board); cf. Gately, SEC Release No. 34-62656 at 20, 2010 WL 3071900 at *13 (noting with reference to section 102 that Act "makes it clear" that failure to comply with obligation to cooperate "presumptively disqualifies a firm from conducting public company audits.").

account of the fact that financial gains from continuing to perform issuer audit work while not fulfilling the responsibilities that accompany PCAOB registration status might fairly be viewed as similar to unjust enrichment. In this case, uncontroverted evidence in the record suggests that Respondents have continued to perform issuer audit work while not cooperating with a PCAOB investigation.[19/]

We have also considered a factor analogous to the section 21B factor concerning whether a person has previously been found by another appropriate regulatory agency or a self-regulatory organization ("SRO") to have violated relevant federal or state laws or SRO rules. We view findings of a state board of accountancy as a potentially relevant factor in this analysis.[20/] Evidence of O'Donnell's Colorado Board disciplinary

[19/] The record evidence on this point is found in issuers' Commission filings containing what purport to be audit reports issued by the Firm after the December 18, 2009 deadline for responding to the December 14 ABDs. Exhibits to the Division's Motion for Entry of a Default Decision include copies of such filings, authenticated by an attestation from the Commission's Records Officer, containing what purport to be five audit reports issued by the Firm from January 5 to March 15, 2010. Exhibits to that motion also include other issuer Commission filings containing what purport to be 20 audit reports issued by the Firm from March 24 to April 15, 2010, although these exhibits are not authenticated by an attestation from a Commission official. In addition, the Division's July 1, 2010 Motion to Adduce Additional Evidence ("July 1 Motion") seeks to add to the record similar evidence of what purport to be four other audit reports issued by the Firm after the Hearing Officer's Initial Decision, although these filings are also not authenticated by an attestation from a Commission official. The filings authenticated by a Commission official's attestation do not conclusively establish that the Firm issued the included audit reports, but they are evidence that the Firm did so, and Respondents have not disputed the point. The filings not authenticated by a Commission official's attestation are slightly less reliable evidence but, in light of the nature and general public availability of the filings, not so much less reliable as to require exclusion from any consideration here, particularly since Respondents have neither disputed the point nor opposed the July 1 Motion. We grant the July 1 Motion and allow the additional evidence into the record.

[20/] Section 21B's term "appropriate regulatory agency" is defined in the Exchange Act and includes only certain federal regulators. We proceed here by analogy to, not by application of, Section 21B. Section 2(a)(1) of the Act defines "appropriate State regulatory authority" to include "the State agency or other authority responsible for the licensure or other regulation of the practice of accounting in the history, described above, includes findings of multiple instances of failing to provide required information to the Colorado Board. As discussed above, that evidence is only in the form of information of which we have taken official notice, but Respondents have had an opportunity to dispute the information and have not done so. In any event, we cite the evidence in this context only as additional information consistent with, but not essential to, a determination to impose a civil money penalty in this case.

In light of the factors described above, we have determined to impose a civil money penalty. We turn now to consideration of the amount of the penalty. The Act specifies maximum penalty amounts, and those specified amounts are from time to time subject to penalty inflation adjustments published in the Code of Federal Regulations. For conduct occurring after March 3, 2009 (the period encompassing Respondents' noncooperation), the Act, as adjusted, authorizes the Board to impose a civil money penalty of up to $900,000 for a natural person and up to $17.8 million for other persons in cases involving intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct.[21/]

In this case we have determined to impose a civil money penalty of $75,000 on O'Donnell.[22/] While this is well below the maximum penalty that we could impose, it nonetheless reflects the seriousness of the noncooperation, including the harm to investors from the possibility that such noncooperation may have prevented the Board from uncovering evidence that would have revealed failures or violations warranting an even steeper penalty. We also view it as sufficient to deter similar noncooperation by others.

State or States having jurisdiction over a registered public accounting firm or associated person thereof."

[21/] See Sections 105(c)(4)(D) and 105(c)(5) of the Act; 17 C.F.R. § 201.1004 Table IV; see also PCAOB Rules 5300(b)(1) and 5300(a)(4). For sanctionable conduct in that same period that does not involve intentional or knowing (including reckless) conduct or repeated instances of negligent conduct, the Act, as adjusted, authorizes the Board to impose a civil money penalty of up to $120,000 for a natural person and $2.375 million for other persons.

[22/] Because the Firm is a professional corporation of which O'Donnell is the sole principal and there is no evidence that any other person could have caused the Firm to respond to the ABD, we conclude that, in these circumstances, no additional purpose would be served by imposing a separate civil money penalty on the Firm.

V.

For the reasons described above, we conclude that, in order to protect the interests of investors and to further the public interest, the Firm's PCAOB registration should be permanently revoked, O'Donnell should be permanently barred from associating with any registered public accounting firm, and a civil money penalty of $75,000 should be imposed against O'Donnell.[23/]

An appropriate order will issue.[24/]

By the Board.

[23/] All funds collected by the Board as a result of the assessment of civil money penalties shall be used in accordance with Section 109(c)(2) of the Act.

[24/] The portion of the Division's September 21 Motion that seeks to add to the record the public portion of the Board's July 30, 2009 inspection report on the Firm is denied. The public portion of the report was expanded in September 2010 to disclose quality control criticisms, which, by law and PCAOB Rules, are publicly disclosed only if a firm fails to address those criticisms to the Board's satisfaction within 12 months after the report is issued. The public portion of the report also discloses that the Firm did not provide any response to a draft of the report when given the opportunity (afforded to all firms) to do so. The Division argues that the Firm's "failure to address the quality control criticisms . . . or to comment on the draft report, is material and relevant to the Board's determination of what sanctions should be imposed upon the Firm in this case." Neither point, however, is relevant to sanctions. Registered firms are not required to respond to draft inspection reports, and the choice not to do so has no bearing on a sanctions analysis. Nor is failure to address inspection report quality control criticisms – which are not adjudicated findings of misconduct – a violation of the Act or PCAOB Rules. Such a failure has the statutorily prescribed consequence of public disclosure of the criticism, but it has no bearing on a sanctions analysis. Where warranted, the Board may follow up through enforcement action addressing the conduct that gave rise to the report criticism, but the appropriateness of sanctions would depend upon the Division establishing through the adjudicative process that a firm had failed to comply with PCAOB standards, not merely that inspection report criticisms had not been addressed to the Board's satisfaction.

PCAOB
Public Company Accounting Oversight Board

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Larry O'Donnell, CPA, P.C. and Larry O'Donnell, CPA Respondents.	PCAOB File No. 105-2010-002 **ORDER IMPOSING SANCTIONS** October 19, 2010

On the basis of the Board's opinion issued this day, it is

ORDERED that Larry O'Donnell, CPA, is permanently barred from associating with any registered public accounting firm; and it is further

ORDERED that Larry O'Donnell, CPA, P.C.'s registration with the Board is permanently revoked; and it is further

ORDERED that Larry O'Donnell, CPA, shall pay a civil money penalty in the amount of $75,000 by (a) United States postal money order, certified check, bank cashier's check, or bank money order, (b) made payable to the Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below and (d) submitted under a cover letter which identifies Larry O'Donnell, CPA, as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: J. Gordon Seymour, General Counsel and Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date: If a respondent does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against a respondent on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If a respondent files an application for review by the Commission or the Commission orders review of sanctions ordered against a respondent, the effective date of the sanctions ordered against that respondent shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board.

J. Gordon Seymour
Secretary

October 19, 2010

PCAOB
Public Company Accounting Oversight Board

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Davis Accounting Group, P.C. and Edwin R. Davis, Jr., CPA,

Respondents.

PCAOB File No. 105-2009-004

FINAL DECISION

March 29, 2011

Appearances

Richard G. Jacobus, Esq., Noah A. Berlin, Esq., Joel D. Schwartz, Esq., Washington DC, for the Division of Enforcement and Investigations.

Brent R. Baker, Esq., Elliott N. Taylor, Esq., Parsons Behle & Latimer, Salt Lake City, UT, for Respondents.

I.

Davis Accounting Group, P.C. ("DAG"),[1] a registered public accounting firm, and Edwin R. Davis ("Davis") appeal from a hearing officer's decision permanently revoking DAG's registration with the Board, permanently barring Davis from association with any registered public accounting firm, and imposing a $25,000 civil money penalty on Davis and DAG, jointly and severally, for failing to cooperate in a PCAOB investigation. The hearing officer issued his decision after granting summary disposition in favor of the Division of Enforcement and Investigations (the "Division") as to Respondents' liability and holding a hearing as to sanctions. We base our findings on a *de novo* review of the record, except as to those findings not challenged on appeal. We find that Respondents engaged in conduct constituting noncooperation with an investigation.

[1] On December 14, 2010, the Respondent firm filed a Form 3 with the Board reporting that it had changed its name, effective October 1, 2010, to Etania Audit Group P.C. This decision refers to the Respondent firm as Davis Accounting Group or DAG.

Because of that conduct, we permanently revoke the registration of DAG, permanently bar Davis from association with a registered public accounting firm, and impose a civil money penalty of $75,000 on Davis.

II.

DAG is a Utah professional corporation with offices in Cedar City, Utah. Davis is the president and sole owner of DAG. DAG has been registered with the PCAOB pursuant to Section 102 of the Sarbanes-Oxley Act of 2002 (the "Act") since November 2004, and, at all relevant times, Davis has been an associated person of a registered public accounting firm as defined in Section 2(a)(9) of the Act and Rule 1001(p)(i).

A. Facts Established on Summary Disposition Concerning Liability

In November 2007, in the course of an informal inquiry pursuant to Rule 5100, the Division began requesting information from Respondents concerning DAG's audits of three issuers. Although Respondents repeatedly advised the Division that they were in the process of complying, and requested extensions of time to do so, Respondents did not provide the requested documents.

On April 23, 2008, the Board issued an Order of Formal Investigation ("OFI") pursuant to Rule 5101(a)(1) authorizing an investigation of DAG and its associated persons. The OFI stated that the Board had received information from its staff indicating that DAG and one or more of its associated persons might have violated PCAOB rules and standards in various respects in connection with DAG's audits for the same three issuer clients referred to in the Division's November 2007 informal request. The OFI authorized the Division to conduct a formal investigation and to issue Accounting Board Demands ("ABDs") to obtain information relevant to the matters described in the OFI.

On May 2, 2008, pursuant to the OFI and Rule 5103, the Division sent ABDs to DAG and Davis. Although each Respondent was sent a separate ABD, the ABDs were identical in substance, and required Respondents to produce documents relating to DAG's audits of the three issuers, as well as documents relating to DAG's internal operations, such as the firm's document retention policy. The document demands set forth in the ABDs were similar to the requests set forth in the Division's November 2007 informal request.

The ABDs required Respondents to produce the requested documents by May 16, 2008, but Respondents did not produce any documents or otherwise respond to the ABDs by that date. On July 22, 2008, having received no response to the ABDs from Respondents, the Division sent Davis a letter reminding him of Respondents' obligation to provide the documents. The letter also extended the time for Respondents to produce the documents until July 25, 2008.

Respondents did not produce any documents by the July 25, 2008, deadline. Instead, on that date, they sent a letter signed by Davis to the Division, by facsimile. In the letter, Davis stated that he had "been contacted by the Division of Professional Licensing of the State of Utah for resolution of this matter," and that he was "currently preparing documents . . . for delivery to them, as instructed." The letter concluded: "If you wish to alter this procedure for handling this matter, please advise. Otherwise, I will proceed to complete the review of the documents and audit evidence on a local level with the State people."

The Division responded on the same day with a letter, sent by facsimile and FedEx, advising Respondents that they were required to send the documents called for by the ABDs to the Division at the PCAOB's Washington, DC, offices, and could "not satisfy the requirements of the ABD[s] by sending the demanded documents to any another [sic] address or agency." The letter reaffirmed the ABDs and stated that production of responsive documents was expected by July 30, 2008.

Instead of producing the documents, on July 31, 2008, Respondents sent the Division a letter signed by Davis, by facsimile. In the letter, Davis represented that the documents called for by the ABDs "have not been completely processed into the Summation format [called for by the ABDs] at this time, and I anticipate that I will receive them back next week. I will forward them to your office as soon as they are in-hand in the proper format that you have requested." In addition, Davis stated that he had failed to provide the documents earlier because his father had suffered serious injuries, and he had needed to take care of "certain family matters." He also stated that his mother-in-law would be undergoing life-threatening surgery and that he would be "with my family for the next few days while we see to her recovery and long-term outcome." Based on those circumstances, the letter requested that the deadline for providing the documents called for by the ABDs be extended until August 15, 2008. On August 6, 2008, the Division sent Respondents a letter, by facsimile and U.S. mail, extending the deadline to August 15.

Once again, Respondents failed to produce the documents by the deadline. Instead, on August 15, 2008, Respondents sent the Division, by facsimile, a letter signed by Davis stating that he was "still in a severe bereavement situation with my family," and requesting "a final extension of time to September 5, 2008, to provide the information in the format indicated." This time, the Division responded on August 22, 2008, with a letter, sent by facsimile and FedEx, in which the Division summarized the correspondence between the Division and Respondents. Instead of extending the deadline once again, the letter advised Davis: "Failure by you or your firm to produce the documents required under the ABD by September 5, 2008 will be considered by [the Division] in any determination it makes as to whether non-cooperation proceedings should be initiated against you or your firm."

Respondents did not produce the documents by September 5. Accordingly, on October 17, 2008, the Division sent Respondents a letter expressing the Division's intention to recommend that the Board commence a disciplinary proceeding against Respondents for their failure to comply with the ABDs. The letter advised Respondents that, in accordance with Rule 5109(d), they could submit a statement of position to the Board addressing whether the Board should commence a disciplinary proceeding.

On October 31, 2008, Respondents responded with a letter, signed by Davis, stating that they had "not, in any way or circumstance, deliberately or intentionally failed to comply with the PCAOB's demand for documents." The letter stated that Davis had been "in a position of personal bereavement" and "a state of depression for which I am now under my physician's care and prescribed medication." Davis represented that "all of the resources that I have at my disposal . . . will be brought to bear in the next two weeks to provide the information requested." He concluded: "I will contact [Division staff] with the notification of time for delivery [of the documents] in the near future."

The Division responded on the same day with a letter indicating that the Division "is awaiting production of the demanded documents." The Division advised Respondents that it had taken Davis's personal and family situations into account, and would take into consideration Respondents' production of documents, if that occurred, but still intended to recommend that the Board commence a disciplinary proceeding.

In January 2009, Respondents, through counsel, represented initially that they expected to produce the documents by January 23, 2009, and subsequently that they would "likely" produce them on January 26, 2009, but they did not do so.[2] The Division's summary disposition papers established that as of January 21, 2010, Respondents had still not produced any documents to the Division in response to the ABDs.

The Division's summary disposition papers and prior filings also included uncontroverted evidence that while Respondents were failing to produce any documents in response to the ABDs, they were continuing to issue audit reports for issuers that were included in the issuers' public filings with the SEC. Over the entire period from the issuance of the ABDs in May 2008 through the filing of the Division's motion for summary disposition, DAG issued more than 30 audit reports for issuers.

B. Additional Facts Established at the Hearing on Sanctions

In mid-2007, after Davis's father suffered a serious injury and a young neighbor child was killed in an accident, Davis "found [himself] to be extremely lethargic, ineffective." In October 2007, he consulted his family physician. According to the physician's contemporaneous records, Davis said that he felt like he had "a low grade fever the past [month]"; that he had "[occasional] weakness, diarrhea, [and] depression"; and that he was "having problems concentrating . . . and staying on task." The physician diagnosed "dysthymia"—a form of depression—and prescribed an antidepressant.

On December 10, 2008, Davis saw his personal physician for the second time concerning his depression. According to his physician's contemporaneous records, Davis reported that he had been "doing well" on the antidepressant that had been prescribed "until just recently, when he started dysthymic symptoms." The physician diagnosed "dysthymia with seasonal worsening," increased the antidepressant dosage, and scheduled a one-month follow-up appointment.

As planned, Davis saw his physician on January 8, 2009. According to the physician's records, on that occasion Davis reported that, on his own, he had tried one dose of a different antidepressant medication "and felt a lot better," with "more energy," but that he "hadn't seen much response" from the higher dosage of the antidepressant that the physician had prescribed in December 2008. The physician changed Davis's

[2] The record evidence on this point incorrectly states that the first of these communications was in January 2008, but it is clear from the context and other materials that it was in January 2009.

medication to the other antidepressant and indicated that Davis should return for a follow-up appointment in two months.

In April 2009, Davis received a grand jury subpoena to DAG requiring production of documents relating to several DAG audit clients and individuals associated with those clients. In July 2009, Davis received a subpoena from the SEC for documents relating to a client.[3/]

Although the physician's notes from Davis's January 2009 appointment indicate a two-month follow-up, Davis did not see his physician again until November 2009. The physician's notes indicate that at that appointment Davis advised that his "[d]epression symptoms [were] better," and that he had gone off the antidepressant medication on his own. The notes indicate that the treatment plan for Davis was to continue off the antidepressant. Davis testified, however, and his prescription records confirm, that he resumed taking the antidepressant in December 2009.

Respondents finally produced some documents to the Division in response to the ABDs in February 2010. In a February 22, 2010, letter to the Division, counsel for Respondents stated that they were sending approximately 2,800 pages as "the first tranche of a rolling production . . . ." Respondents offered no evidence, however, that, as of the April 6 hearing date, they had submitted any additional documents.

Davis has never been hospitalized for depression, and he has not sought, nor has his physician prescribed, any form of treatment other than antidepressants. Davis testified that, from the outset of his symptoms on, he has experienced good and bad days. During the good days, Davis testified, he has been able to work effectively, sometimes well into the night, and has continued to operate his business, including performing and signing off on audits. In 2008, when the ABDs were served, he had a small and inexperienced staff, but by the time of the hearing, his staff included an accounting manager, who supervises a staff of four; a tax manager, who supervises a staff of one; an audit manager, who is responsible for DAG's activities in China[4/] and

[3/] In January 2010, Respondents produced approximately 1618 pages in response to the SEC subpoena, and in February 2010 they produced approximately 2,139 pages in response to the grand jury subpoena.

[4/] In June 2008, the month after the Division issued the ABDs to Respondents, Davis traveled to China for a week to negotiate an agreement with a Chinese accounting firm.

India; another CPA, who supervises a staff of one; and an administrative assistant, a receptionist, and a computer person. Davis oversees the activities of DAG's staff, and, in particular, has retained exclusive authority to issue audit reports, sign checks, generate payroll, and take on certain types of assignments.

During the period of noncooperation, DAG continued to issue audit reports. Although Davis testified that, because of his depression, he could not manage "the stretch" that was required for him to respond to the ABDs, he also conceded that he made a choice to use his good days to issue audit reports and do other DAG work rather than to gather and submit the documents sought by the ABDs.

C. Procedural History

On February 10, 2009, the Board issued an Order Instituting Disciplinary Proceedings ("OIP") against Respondents. The OIP alleged that, by reason of their refusal to cooperate with the investigation, Respondents were subject to disciplinary sanctions pursuant to Section 105(b)(3) of the Act and PCAOB Rule 5300(b).

On March 9, 2009, the hearing officer issued an order holding Respondents in default for failing to file a timely Answer to the OIP. The hearing officer denied Respondents' motion to set aside the default on March 24, 2009 and denied Respondents' renewed motion on April 2, 2009. On April 9, 2009, the hearing officer issued an Initial Decision in which he found that Respondents had refused to cooperate with a Board investigation, and, as authorized by Section 105(b)(3) and Rule 5300(b), revoked DAG's registration and barred Davis from association with any registered public accounting firm.

On April 20, 2009, Respondents filed a petition for Board review of the Initial Decision. On December 17, 2009, the Board issued an order setting aside Respondents' default and remanding the proceeding to the hearing officer for further proceedings. In its order, the Board stated that it was "reluctant, at this point and on the record before us, to foreclose any possibility that Respondents could make out a defense based on 'emotional trauma,' or that Davis's emotional state could be a mitigating factor for purposes of imposing sanctions on Respondents in the event their liability is established."

On January 7, 2010, Respondents filed an Answer to the OIP. On January 25, 2010, the Division filed a motion for summary disposition. On February 16, 2010, Respondents filed their opposition to the Division's motion.

On February 24, 2010, the hearing officer issued an order granting the Division's motion as to liability, but denying it as to sanctions. The hearing officer advised the parties that a hearing would be held to receive such additional evidence as the parties might wish to offer on the issue of sanctions. The hearing was held on April 6, 2010. Davis was the only witness.

On May 13, 2010, the hearing officer issued an initial decision imposing sanctions on Respondents for their noncooperation with the investigation. DAG's registration was revoked, Davis was permanently barred from association with a registered public accounting firm, and a civil money penalty of $25,000 was assessed against Respondents jointly and severally.

On May 26, 2010, two days after the filing deadline prescribed by Rule 5460(a)(2)(ii), Respondents petitioned the Board for review of the initial decision. Although we denied the petition as untimely, on June 10, 2010 we ordered Board review of the initial decision on our own initiative. Respondents filed their opening brief on July 20, 2010. On August 19, 2010, the Division filed its brief in opposition. Respondents' reply brief was filed on September 2, 2010.

III.

A. Summary Disposition Standard

Rule 5427 provides that "[t]he hearing officer shall promptly grant a motion for summary disposition if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a disposition as a matter of law." This rule, in substance, parallels Rule 56 of the Federal Rules of Civil Procedure, as well as Rule 250 of the SEC Rules of Practice. Under these provisions, the ultimate question is whether the record as a whole demonstrates the existence of any factual disputes that must be resolved through a hearing. "[A] party seeking summary judgment [must] make a preliminary showing that no genuine issue of material fact exists. Once the movant has made this showing, the nonmovant must contradict the showing by pointing to specific facts demonstrating that there is, indeed, a trialworthy issue."[5/]

[5/] National Amusements, Inc. v. Town of Dedham, 43 F.3d 731, 735 (1st Cir. 1995).

To preclude summary disposition, any unresolved factual issues must be both genuine and material—"the mere existence of *some* alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no *genuine* issue of *material* fact."[6/] In considering a motion for summary disposition, the record will be viewed most favorably to the nonmoving party, but "we need not credit purely conclusory allegations, indulge in rank speculation, or draw improbable inferences."[7/] "Where the record taken as a whole could not lead a rational trier of fact to find for the nonmoving party, there is no 'genuine issue for trial.'"[8/]

B. Noncooperation with the Investigation

Section 105(b)(3) of the Act authorizes the Board to impose sanctions on any registered public accounting firm or associated person thereof who refuses to cooperate with the Board in connection with an investigation pursuant to Section 105.[9/] The Board issued an OFI on April 23, 2008, authorizing the Division to conduct an investigation of DAG and its associated persons, one of whom is Davis. As authorized by the OFI, the Division issued ABDs to Respondents on May 2, 2008, calling for the production of documents. Yet Respondents provided none of the documents or information called for by the ABDs for over 20 months.

[6/] Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247-48 (1986) (emphasis in original).

[7/] National Amusements, 43 F.3d at 735.

[8/] Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986) (quoting Fed. R. Civ. P. 56(e)).

[9/] Section 105(b)(1) of the Act authorizes the PCAOB to "conduct an investigation of any act or practice, or omission to act, by a registered public accounting firm, any associated person of such firm, or both, that may violate" the Act, the Board's rules, the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, or professional standards. Section 105(b)(2) authorizes the PCAOB to "require the production of audit work papers and any other document or information in the possession of a registered public accounting firm or any associated person thereof, wherever domiciled, that the Board considers relevant or material to the investigation . . . ."

Respondents do not dispute these facts. Rather, they argue on appeal that "Davis established the existence of a genuine issue of material fact as to liability based upon the effect of Davis's debilitating illness which prevented him from complying at a rate of which a healthier individual might be able to accomplish." According to Respondents, "the testimony and documentary evidence offered by Davis supported a finding that Davis was disabled, often incapacitated, and frequently unable to comply with the ABDs, but nevertheless did comply to the best of his diminished ability."[10/]

Respondents, however, offered no evidence that could support a finding that Davis's illness was so severe that it prevented him from producing any documents in response to the ABDs for more than 20 months.[11/] At the time of summary disposition, the only evidence in the record regarding Davis's medical condition consisted of Davis's March 2009 affidavit, submitted in support of Respondents' renewed motion to set aside their default, and a doctor's note he submitted as an exhibit to his affidavit. In his affidavit, Davis represented that there had been a number of events, beginning in May 2007 and continuing into 2008, involving serious health issues for his father, his mother-in-law, and his step-daughter, as well as the death of a neighbor's young child in an accident. As a result of this, Davis said, he was under a doctor's care for depression, which:

> renders me listless, without the ability to focus, or even if a specific task is in front of me, my mind just 'tunes out the world' for an extended period of time. I have only been able to barely manage the tasks of my practice (and sometimes not even to that level) because of a great staff and audit personnel that can take over and handle multiple client assignments. As indicated by my Doctor, I am currently on a strong prescription drug that is having some (but not always) positive results on my condition.

In his two-sentence note, dated March 30, 2009, Davis's doctor confirmed that Davis had been under treatment for depression since 2007 and had recently been switched to

[10/] Although Respondents' reply brief argues that a material fact is in dispute regarding "the degree to which Respondents timely complied with the Board's investigational demands," Respondents have not disputed that they provided no documents in response to the ABDs for over 20 months.

[11/] Indeed, Respondents' brief on appeal states that Davis was "*often* incapacitated, and *frequently* unable to comply with the ABDs" (emphasis added).

a new medication, but he did not express an opinion that the depression had prevented or impeded Davis from complying with the ABDs.

Davis's affidavit and his doctor's note do not establish a genuine issue of fact as to Davis's capacity to comply with the ABDs.[12/] The doctor's note did not indicate that, even as of March 2009, Davis was incapable of responding to the ABDs, and Davis, himself, said that he had "a great staff and audit personnel that can take over and handle multiple client assignments." Respondents have failed to explain why that staff and audit personnel could not also have gathered documents responsive to the ABDs even if Davis himself was incapable of doing so, or why Davis was capable of issuing audit opinions but, at the same time, incapable of complying with the ABDs.

Similarly, none of the evidence introduced at the hearing on sanctions suggests that Davis could not have complied with the ABDs, or that an additional hearing would add in any meaningful way to the record. Davis's doctor's contemporaneous notes show that Davis was diagnosed with dysthymia and prescribed medication but do not indicate that Respondents were incapable of producing documents in response to the ABDs. Moreover, Davis conceded at the hearing that he made a choice to use his "good days" to issue audit reports and do other DAG work, rather than to gather and submit the documents sought by the ABDs.

Respondents also argue that "there were genuine issues as to [Davis's] ability to comply despite the burdens imposed by" a grand jury subpoena and a subpoena from the SEC.[13/] Davis did not even receive the first of these subpoenas, however, until March 2009—10 months after Respondents received the ABDs, and a month after the Board instituted this proceeding. Under those circumstances, no rational finder of fact could conclude that any burden imposed by the subpoenas prevented Respondents from complying with the requirement to cooperate with the Board.

[12/] If we were to determine otherwise—that there was a genuine issue concerning Respondents' capacity to comply—we would then need to determine whether that issue was material to the question of Respondents' liability. Because we find there is no genuine issue concerning capacity, we do not address that materiality question.

[13/] The only exhibits attached to Respondents' opposition to summary disposition were an SEC subpoena, a grand jury subpoena, and emails between Respondents' counsel and SEC and Department of Justice staff regarding Respondents' responses to those subpoenas.

Notwithstanding the undisputed facts described above, Respondents argue that "the Division has failed to produce any evidentiary support that Respondents engaged in conduct amounting to a complete failure or refusal to comply." Although section 105(b)(3) of the Act authorizes the Board to impose sanctions for noncooperation with an investigation if a registered firm or associated person "refuses" to cooperate, we do not understand that provision to limit our sanctioning authority to cases involving an express refusal. To hold otherwise would render section 105(b)(3) a dead letter, since any noncooperating registered firm or associated person could then avoid section 105(b)(3) sanctions merely by refraining from expressly articulating a refusal to cooperate.

In this case, Respondents received repeated demands to comply with the ABDs and were advised of the risk of sanctions for failing to comply. Though we have determined that Respondents were not incapable of complying, Respondents produced no documents for over 20 months, despite requesting, and being granted, a number of extensions. Instead of cooperating with the Board, Davis continued to issue audit reports. These circumstances represent a "refusal" to cooperate for which we may impose sanctions pursuant to Section 105(b)(3). They also, of course, represent a "failure" to cooperate for purposes of Rule 5300(b).

Because there was no genuine issue of material fact as to Respondents' liability, summary disposition was appropriate based on the record developed at that stage of the proceeding, Moreover, the facts established at the hearing on sanctions, which confirm the relevant aspects of the summary disposition record, reinforce our conclusion that further proceedings on Respondents' liability are unnecessary.

IV.

For noncooperation with an investigation, the Board is authorized to revoke or suspend a firm's registration, to bar or suspend an individual from association with any registered public accounting firm, or to impose certain lesser sanctions as the Board considers appropriate and as specified by rule of the Board.[14/] We find that the

[14/] See Section 105(b) of the Act and Rule 5300(b). Respondents appear to argue that Section 105(c)(5) of the Act requires the Board to establish that Respondents engaged in intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct in order to impose certain sanctions. That is incorrect. The limitation in Section 105(c)(5) applies only to "[t]he sanctions and penalties described in subparagraphs (A) through (C) and (D)(ii) of paragraph [105(c)](4)" that the appropriate sanctions for Respondents' failures to produce documents in response to the ABDs are revocation of DAG's registration, a bar against Davis being associated with any registered public accounting firm, and a $75,000 civil money penalty against Davis.

A. Revocation and Bar

The Board's power to investigate possible violations and to impose appropriate sanctions[15] is fundamental to its ability to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[16] Conducting investigations in an appropriate and timely manner depends upon registered firms' and associated persons' compliance with demands for documents and testimony made pursuant to the Board's authority under the Act. Noncooperation frustrates the oversight system by impeding the Board's ability to determine whether violations have occurred for which sanctions should be imposed, including sanctions that would protect investors from further violations, and thus deprives investors of an important protection that the Act was intended to provide.[17]

In this case, Respondents did not produce a single document in response to the ABDs for more than 20 months. Respondents argue that sanctions are not warranted for their noncooperation "because the evidence established that Davis was previously unable to cooperate with the investigation because of his disability, but that as a result

Board may impose upon finding a violation of the Act, the rules of the Board, certain provisions of the securities laws, or professional standards. Sanctions imposed for a failure to cooperate with a Board investigation are imposed not pursuant to Section 105(c)(4) but pursuant to Section 105(b)(3)(A), which provides the Board with independent authority to impose sanctions for a "refus[al] to testify, produce documents, or otherwise cooperate with the Board in connection with an investigation . . . ." In any event, however, the facts described above demonstrate that Respondents' conduct in this case was at least reckless.

[15] See Sections 101(c)(4), 105(b)(1), and 105(c)(4) of the Act.

[16] Section 101(a) of the Act.

[17] Cf. Gately & Associates, LLC, Exchange Act Rel. No. 62656, at 22-23, 2010 WL 3071900, at *15 (August 5, 2010) (recognizing seriousness of failure to cooperate in PCAOB inspection designed, among other things, to uncover misconduct).

of the treatment he received, he will continue his compliance efforts." We have, however, already rejected Respondents' contention that they were unable to cooperate with the investigation.[18/]

Moreover, the facts established at the hearing served only to undermine Respondents' contention that Davis's condition mitigated their failure to cooperate. Davis testified that, from the outset of his symptoms on, he has experienced good and bad days and that during the good days he has been able to work effectively, sometimes well into the night. As he himself conceded, Davis chose to use his good days to operate and develop his business rather than to comply with regulatory requirements. Among other things, Davis traveled to China for a week to negotiate an agreement with a Chinese accounting firm in the month after receiving the ABDs and signed off on Respondents' issuance of more than 30 audit reports during the period in which they did not produce a single document called for by the ABDs. Under these circumstances, Davis's contention that his depression was so incapacitating as to mitigate Respondents' failure to cooperate is entitled to no weight.

Respondents' production of some documents in February 2010 is also not a mitigating factor. That production came more than 20 months after Respondents received the ABDs and a year after the Board instituted these proceedings. Accordingly, we do not credit it for purposes of our determination of the appropriate sanctions.[19/]

We find that Respondents' conduct warrants revocation of DAG's registration and a bar on Davis's association with any registered public accounting firm. In a Board investigation, Respondents received document production demands in response to which they produced none of the demanded documents until more than a year after these proceedings were instituted. They continued not to produce the demanded

[18/] Respondents argue that Davis "was denied the opportunity to produce post-hearing submissions which would have contained additional evidence of the affects [sic] of his medical condition." Respondents, however, had ample opportunity to present any such evidence in opposition to summary disposition and at the hearing.

[19/] Cf. Gately & Associates, LLC, Exchange Act Rel. No. 62656, at 23, 2010 WL 3071900, at *15 ("In the context of SRO requests for information, we have long held that the institution of disciplinary proceedings should not be required in order to compel compliance with such requests, and we think the same principles should apply to PCAOB Rule 4006 requests.") (footnote omitted).

documents despite the Division's warnings that such noncooperation could result in disciplinary sanctions. At the same time as they refused to cooperate with the Board, they continued to develop their business and issue audit reports. Davis acknowledged that he made a choice to do these things rather than comply with regulatory requirements.

This type of noncooperation undermines the Board's ability to protect investors and advance the public interest by identifying and addressing misconduct in connection with the audits of public companies' financial statements. In the absence of any mitigating circumstances, such noncooperation indicates a lack of sufficient regard for Board processes and authority designed by statute to protect investors. If DAG were to remain a registered firm and Davis an associated person, they would have opportunities to similarly undermine those processes, and the related investor protection, in the future.[20/]

[20/] On October 25, 2010, the Division filed a Motion to Adduce Additional Evidence that the Division contends is relevant to sanctions because it is additional evidence of the risk Respondents pose if permitted to continue auditing public companies. Specifically, through the October 25 motion and a November 4, 2010 supplement proffering certified copies of certain Utah state court documents, the Division seeks to introduce evidence that in September 2010 Davis was convicted on two counts of unlawful professional conduct in a case arising out of, as Davis acknowledges in his opposition to the Division's motion, "charges for practicing without a license." Respondents' Opposition to the Division of Enforcement and Investigations' Motion to Adduce Additional Evidence, at 2 (Oct. 29, 2010). Respondents do not dispute the fact of the convictions. Citing the requirements of Rules 5441 and 5464 concerning the admission of evidence, however, they oppose the Division's motion on the grounds that the charge "has no bearing on the Board's analysis," and that the Division's motion does not show with particularity that the evidence is material to the case and that there were reasonable grounds for the failure to make the motion sooner than four weeks after the convictions were entered. Id. at 3. The latter argument, concerning the timing of the motion, borders on being frivolous and is not a basis for rejecting the Division's motion. The relevant timing point is that the Division could not have presented the evidence in the proceeding before the Hearing Officer because the convictions had not occurred at that time, and the four weeks between the convictions and the motion does not otherwise constitute such a delay as to require explanation. The argument concerning materiality presents a closer question, given that we would reach the conclusion described in the text even in the absence of this additional evidence. We agree with the Division, however, that the conviction is further evidence

B. Civil Money Penalties

We also find that Respondents' conduct warrants the imposition of a civil money penalty. Section 105(c)(4) of the Act authorizes the Board to impose such "disciplinary or remedial sanctions as it determines appropriate" for violations of certain laws, rules, and standards, and specifies that those sanctions may include civil money penalties up to specified maximum amounts. Although that provision is separate from section 105(b)(3)'s provision authorizing sanctions for noncooperation with an investigation, section 105(b)(3) authorizes the Board to impose "such other lesser sanctions" (in addition to bars, revocations, and suspensions) as the Board specifies by rule, and the Board's rules implementing that authority incorporate, as such lesser sanctions, the civil money penalty provisions found in section 105(c)(4).[21/]

In considering whether a civil money penalty is an appropriate disciplinary or remedial sanction, we are guided by the statutorily prescribed objectives of any exercise of our sanctioning authority: the protection of investors and the public interest.[22/] We are also cognizant that the Commission, in reviewing any contested sanctions that we impose, is called upon to do so with "due regard for the public interest and the protection of investors."[23/]

that Respondents pose the risk described above. Cf. Joseph Ricupero, Exchange Act Rel. No. 62891 at 11, 2010 WL 3523186 at *7-8 (September 10, 2010) (sustaining bar on individual's association with any National Association of Securities Dealer member because of individual's failure to respond to information requests, and noting that individual's prior disciplinary history is "further evidence" that individual posed risk to investing public should he re-enter securities industry). We therefore grant the Division's motion and allow the additional evidence into the record.

[21/] See PCAOB Rule 5300(b)(1) (incorporating sanctions described in Rule 5300(a)(4)).

[22/] See section 101(a) of the Act (Board established "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports"); section 101(c)(5) (Board to perform duties or functions as the Board determines necessary "to carry out this Act, in order to protect investors, or to further the public interest").

[23/] Section 107(c)(3) of the Act.

For guidance, we also look to the factors enumerated in, and the Commission's application of, a somewhat comparable statutory authorization in the Securities Exchange Act of 1934 ("Exchange Act"). Like the authorization to the Board in the Act, section 21B of the Exchange Act authorizes the Commission to impose civil money penalties in administrative proceedings, up to specified maximum amounts, if the Commission finds that "such penalty is in the public interest."[24/] Unlike the Act, however, Exchange Act section 21B provides guidance regarding relevant factors "[i]n considering under this section whether a penalty is in the public interest."[25/] The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.

Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.[26/] The Commission has imposed civil money penalties under section 21B on numerous occasions, emphasizing various of these factors, including in cases in which the Commission imposed a bar in addition to the civil money penalty.[27/]

[24/] Section 21B(a) of the Exchange Act.

[25/] Section 21B(c) of the Exchange Act.

[26/] See Next Financial Group, Inc., 93 SEC Docket 1369, 2008 WL 2444775 at *49 (June 18, 2008) (Initial Decision) ("Not all factors may be relevant in a given case, and the factors need not all carry equal weight").

[27/] See, e.g., VFinance Investments Inc., Exchange Act Rel. No. 62448, at 27-28, 2010 WL 2674858, at * 18 (July 2, 2010) (barring individual from association with any broker or dealer in principal or supervisory capacity and imposing $30,000 civil money penalty described as "warranted to create a monetary incentive for Respondents and other industry participants to fulfill their recordkeeping obligations and cooperate with regulatory inquiries – particularly when, as in this case, such person is aware that

The courts have recognized that Commission sanctions involving bars and section 21B civil money penalties are appropriate, and should be upheld absent a "gross abuse of discretion," given that "Congress has charged the Commission with protecting the investing public," and the question of appropriate remedies is "peculiarly a matter for administrative competence."[28] The Board, too, is charged to exercise its sanctioning authority "as the Board considers appropriate"[29] (subject to Commission review) to protect the investing public. Looking to the Exchange Act section 21B factors

compliance may reveal regulatory violations potentially resulting in disgorgement or monetary penalties"); Gregory O. Trautman, Exchange Act Rel. No. 61167A, at 42, 44, 2009 WL 4828994, at *22-23 (December 15, 2009) (barring individual from association with any broker or dealer and imposing a $120,000 civil money penalty as "necessary to deter others" from such conduct, and in light of fact that conduct involved deception causing harm to others and resulting in enrichment of individual's firm); Guy P. Riordan, Exchange Act Rel. No. 61153, at 38-39, 2009 WL 4731397, at *21-22 (December 11, 2009) (barring individual from association with any broker or dealer and imposing separate $100,000 civil money penalties for each of five violations in light of fact that conduct involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement and resulted in substantial pecuniary gain), pet. denied, 627 F.3d 1230 (D.C. Cir. 2010); Joseph John VanCook, Exchange Act Rel. No. 61039A, at 31-32, 2009 WL 4005083, at *18 (November 20, 2009) (barring individual from association with any broker or dealer and imposing $100,000 civil money penalty described as "an amount necessary to deter VanCook from future misconduct" and that "will also have a remedial effect of deterring others from engaging in the same misconduct"). Trautman, Riordan, and VanCook all involved financial harm to investors that the Commission orders addressed through substantial disgorgement remedies (more than $600,000 in Trautman, more than $900,000 in Riordan, and more than $500,000 in VanCook), underscoring that the separate civil money penalty is imposed for a purpose distinct from making a financially harmed victim whole.

[28] Rizek v. SEC, 215 F.3d 157, 160 (1st Cir. 2000) (upholding bar on individual's association with any broker, dealer, member of a national securities exchange, or member of a registered securities association and imposition of $100,000 civil money penalty) (quoting A.J. White & Co. v. SEC, 556 F.2d 619, 624 (1st Cir. 1977), and Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 185 (1973)).

[29] Section 105(b)(3)(A)(iii) of the Act; see also Section 105(c)(4) of the Act ("Board may impose such disciplinary or remedial sanctions as it determines appropriate").

and precedent for guidance on protecting investors and advancing the public interest through civil money penalties,[30] we conclude that a civil money penalty is appropriate in this case.

In response to the ABDs, Respondents disregarded their obligation to cooperate with the Board's investigation. On the record, as described above, it is clear that this disregard was deliberate or reckless. Despite receiving extensions of the deadline for producing documents, follow-up demands, warnings about disciplinary action, and notice of the institution of disciplinary proceedings, Respondents produced none of the demanded documents for over 20 months.

We also conclude that Respondents' conduct caused at least indirect harm to others. Investors and markets are put at risk, and perhaps harmed in ways that never become known, when a regulatory investigation is improperly thwarted by a regulated person's refusal to provide information. Such noncooperation undermines the Board's ability to protect investors and advance the public interest by identifying and addressing misconduct in connection with the audits of public companies' financial statements. The undermining of this protection is a harm to investors and markets that factors into a sanctions analysis.[31]

We have also considered together the section 21B factors concerning whether any person was unjustly enriched and whether there is a need to deter such person and other persons from similar noncooperation. The obligation of registered firms and associated persons to cooperate with the Board is a fundamental aspect of PCAOB

[30] Relevant, and similar, guidance is also provided by the courts even outside of the section 21B context. See McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005) (factors relevant in deciding whether a sanction is appropriately remedial include "[t]he seriousness of the offense, the corresponding harm to the trading public, the potential gain to the [offender] for disobeying the rules, the potential for repetition in light of the current regulatory and enforcement regime, and the deterrent value to the [offender] and others").

[31] Cf. Gately, Exchange Act Rel. No. 62656, at 19, 2010 WL 3071900, at *13 (recognizing as obvious the risk to investors and markets posed by a failure to produce information in a Board inspection).

registration status.[32] Yet, under the processes set out in the Act and the Board's rules, it necessarily takes some time before Board disciplinary sanctions in response to noncooperation are imposed and take effect. During that time, nothing prevents the firm or person from continuing to reap financial benefits from performing audit services for issuers, all the while ignoring the corresponding cooperation obligation that is essential to the Board's ability to protect investors in those issuers.

In short, in the absence of a civil money penalty, noncooperation with the Board might seem to certain kinds of individuals – who fear that cooperation will provide information that would lead to sanctions for violations of laws, rules, or standards – to be the course most likely to prolong the period of their registration and allow them to maximize their income from issuer audit work before being sanctioned. A civil money penalty for noncooperation is appropriate both as a deterrent to that kind of reasoning and conduct,[33] and, where applicable, to take account of the fact that financial gains from continuing to perform issuer audit work while not fulfilling the responsibilities that accompany PCAOB registration status might fairly be viewed as similar to unjust enrichment. In this case, Davis acknowledged in his testimony that Respondents continued to perform issuer audit work, and issue audit reports, during the period that they were not responding to the ABDs.[34]

[32] Section 105(b)(3) is only one of the statutory provisions reflecting the importance of such cooperation. See also section 102(b)(3) of the Act (requiring registration applicants to consent to cooperate with Board requests for testimony and production of documents, to agree to secure and enforce similar consents from their associated persons, and to acknowledge and agree that such cooperation is a condition to the continuing effectiveness of the firm's registration with the Board); cf. Gately, Exchange Act Rel. No. 62656, at 20, 2010 WL 3071900, at *13 (noting with reference to section 102 that Act "makes it clear" that failure to comply with obligation to cooperate "presumptively disqualifies a firm from conducting public company audits").

[33] See VFinance Investments, Inc., Exchange Act Rel. No. 62448, at 27-28, 2010 WL 2674858, at * 18 (civil money penalty warranted to create incentive for respondents and other industry participants to cooperate with regulatory inquiries, particularly when aware that compliance may reveal regulatory violations potentially resulting in disgorgement or monetary penalties).

[34] Davis's hearing testimony did not specify the volume of such work performed while not responding to the ABDs, but the Division introduced evidence of 34 audit reports issued by DAG for issuers during that period, and Respondents have not

We have also considered a factor analogous to the section 21B factor concerning whether a person has previously been found by another appropriate regulatory agency or an SRO to have violated relevant federal or state laws or SRO rules. We view findings in a state disciplinary proceeding as a potentially relevant factor in this analysis.[35/] As discussed above, Davis was convicted on two misdemeanor counts of unlawful professional conduct in a case arising out of charges for practicing public accounting without a license. We cite this evidence only as additional information consistent with, but not essential to, a determination to impose a civil money penalty in this case.

In light of the factors described above, we have determined to impose a civil money penalty. We turn now to consideration of the amount of the penalty. The Act specifies maximum penalty amounts, and those specified amounts are from time to time subject to penalty inflation adjustments published in the Code of Federal Regulations. For conduct occurring after February 14, 2005 but before March 3, 2009 (the period during which the misconduct leading up to the institution of this proceeding occurred and this proceeding was instituted), the Act, as adjusted, authorizes the Board to impose a civil money penalty of up to $800,000 for a natural person and up to $15.825 million for other persons in cases involving intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct.[36/]

disputed the point. The evidence consists of issuers' SEC filings containing what purport to be audit reports issued by DAG after the May 16, 2008 deadline for responding to the ABDs.

[35/] Section 21B's term "appropriate regulatory agency" is defined in the Exchange Act and includes only certain federal regulators. We proceed here by analogy to, not by application of, Section 21B.

[36/] See Sections 105(c)(4)(D) and 105(c)(5) of the Act; 17 C.F.R. § 201.1003 Table III; see also PCAOB Rules 5300(b)(1) and 5300(a)(4). For sanctionable conduct in that same period that does not involve intentional or knowing (including reckless) conduct or repeated instances of negligent conduct, the Act, as adjusted, authorizes the Board to impose a civil money penalty of up to $110,000 for a natural person and $2.1 million for other persons.

In this case we have determined to impose a civil money penalty of $75,000 on Davis.[37] While this is well below the maximum penalty that we could impose, it nonetheless reflects the seriousness of the noncooperation, including the harm to investors from the possibility that such noncooperation may have prevented the Board from uncovering evidence that would have revealed failures or violations warranting an even steeper penalty. We also view it as sufficient to deter similar noncooperation by others.

V.

For the reasons described above, we conclude that, in order to protect the interests of investors and to further the public interest, DAG's PCAOB registration should be permanently revoked, Davis should be permanently barred from associating with any registered public accounting firm, and a civil money penalty of $75,000 should be imposed against Davis.[38]

An appropriate order will issue.[39]

By the Board.

[37] Because DAG is a professional corporation of which Davis is the sole owner, we conclude that, in these circumstances, no additional purpose would be served by imposing a separate civil money penalty on DAG.

[38] All funds collected by the Board as a result of the assessment of civil money penalties shall be used in accordance with Section 109(c)(2) of the Act.

[39] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Davis Accounting Group, P.C. and Edwin R. Davis, Jr., CPA,

Respondents.

PCAOB File No. 105-2009-004

ORDER IMPOSING SANCTIONS

March 29, 2011

On the basis of the Board's opinion issued this day it is

ORDERED that Edwin R. Davis, Jr. is permanently barred from associating with any registered public accounting firm; and it is further

ORDERED that the registration of Etania Audit Group P.C. (formerly known as Davis Accounting Group, P.C.) is permanently revoked; and it is further

ORDERED that Edwin R. Davis, Jr. shall pay a civil money penalty in the amount of $75,000 by (a) United States postal money order, certified check, bank cashier's check, or bank money order, (b) made payable to the Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies Edwin R. Davis, Jr. as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: J. Gordon Seymour, General Counsel and Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date: If a respondent does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against a respondent on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the

Commission to order review. If a respondent files an application for review by the Commission or the Commission orders review of sanctions ordered against a respondent, the effective date of the sanctions ordered against that respondent shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002. *

By the Board.

J. Gordon Seymour
Secretary

March 29, 2011

* Pursuant to Commission actions lifting the stay imposed by Section 105(e), the bar and revocation became effective on June 14, 2011, and the civil money penalty became effective on October 18, 2011.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of
Cordovano and Honeck LLP and
Samuel D. Cordovano, CPA,

Respondents.

PCAOB File No. 105-2010-004

Notice of Finality of Initial Decision

August 29, 2011

On July 6, 2011, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Cordovano and Honeck LLP be permanently revoked and that Samuel D. Cordovano be permanently barred from being an associated person of a registered public accounting firm.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final pursuant to PCAOB Rule 5204(d).

Effective Date of Sanctions: If a respondent does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against a respondent on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If a respondent files an application for review by the Commission or the Commission orders review of sanctions ordered against a respondent, the effective date of the sanctions ordered against that respondent shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

J. Gordon Seymour
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Secretary

August 29, 2011

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In the Matter of Cordovano and Honeck LLP and Samuel D. Cordovano, CPA,

Respondents.

PCAOB No. 105-2010-004

Hearing Officer – DMF

INITIAL DECISION

July 6, 2011

Summary

Respondent Samuel D. Cordovano, CPA, violated Section 105(c)(7)(A) of the Sarbanes-Oxley Act of 2002 (Act) and PCAOB Rules 5000 and 5301(a) by willfully becoming or remaining an associated person of a registered public accounting firm after being barred from such association, and Respondent Cordovano and Honeck LLP (Firm) violated Section 105(c)(7)(A) of the Act and PCAOB Rules 5000 and 5301(b) by permitting Respondent Cordovano to become or remain an associated person of the Firm when it knew that Cordovano was barred from such association. For these violations, both of which resulted from intentional or knowing conduct, including reckless conduct, Respondent Cordovano is permanently barred from association with any registered public accounting and Respondent Firm's PCAOB registration is permanently revoked.

DECISION

I. Introduction

The Board issued the Order Instituting Disciplinary Proceedings (OIP) in this matter on November 5, 2010. The OIP alleged that, after the Board issued a consent order barring Respondent Samuel D. Cordovano, CPA (Cordovano), from being an associated person of a registered public accounting firm on December 18, 2008 (the 2008

Order),[1] Cordovano engaged in certain specified activities, in connection with the audits of four issuers performed by Respondent Cordovano and Honeck LLP (Firm), that caused him to be an associated person of the Firm. The OIP charges that Cordovano thereby violated Section 105(c)(7)(A) of the Sarbanes-Oxley Act of 2002 (the Act), and PCAOB Rules 5301(a) and 5000, and that the Firm thereby violated Section 105(c)(7)(A) of the Act and Rule 5301(b).

On November 29, 2010, Respondents filed an Answer to the OIP in which they admitted some factual allegations, denied other factual allegations, and denied that they had violated the Act or PCAOB rules, as charged. An evidentiary hearing was held in Denver, Colorado, from March 7 through March 11, 2011. At the hearing, the Division of Enforcement and Investigations (Division) called three witnesses: Heather Zhou and Christine Quijote-Oakes, both former Firm employees, and Richard Fleischman, a CPA partner in another registered public accounting firm, who the Firm retained to serve as the independent reviewer for one of the relevant audits. Respondents called five witnesses: Cordovano; Cole Honeck, co-owner of the Firm; Jeffrey Ginsburg, a former Firm employee; Marcel Noordeloos, the former CFO of one of the relevant issuers; and Mickie Koslofsky, the former CFO of another of the relevant issuers. In addition, the Division and Respondents each offered a substantial number of exhibits—primarily contemporaneous emails and other documents—and the parties offered the 2008 Order and two sets of stipulations as joint exhibits.

Following the hearing, the Division filed its post-hearing submission on April 21, 2011 and Respondents filed their post-hearing submission on May 24, 2011. On May 25,

[1] See In the Matter of Cordovano and Honeck, P.C. and Samuel D. Cordovano, CPA, PCAOB Release No. 105-2008-004 (Dec. 18, 2008).

2011, the Division notified the Hearing Office that it would not file a reply to Respondents' post-hearing submission.[2]

II. Facts

A. Background

Cordovano, who is 63 years old, moved to Colorado and qualified as a CPA after graduating from college. He worked as an auditor for the federal government for five years, worked for two years in a CPA firm, and, after that firm disbanded, established the predecessor of the Firm as a sole proprietorship in 1986. Cordovano hired Cole Honeck as a junior accountant in 1993, after Honeck graduated from college. Honeck obtained his CPA license in Colorado in 1995. At that time, the Firm consisted of just Cordovano, as owner, and Honeck, as his only employee. Tr. 523-24, 526, 869.

In approximately 1997 or 1998, Cordovano formed a partnership with another CPA, who assumed a 50% ownership in the Firm. That partnership continued until 2002, when the other CPA left the partnership, and Honeck purchased her 50% share of the business. Cordovano and Honeck held equal shares of the Firm until early 2010, when Colorado suspended Cordovano's CPA license, based on the 2008 Order. To comply with Colorado rules requiring that CPAs hold a majority interest in CPA firms, Honeck became a 51% owner of the Firm, and Cordovano's ownership share decreased to 49%. Cordovano and Honeck continued to hold those interests in the Firm as of the date of the hearing.[3] Tr. 525-27, 869-72; J-2 at ¶ 2.

[2] In this Initial Decision, "Tr." refers to the hearing transcript; "D-" refers to the Division's exhibits in evidence; "R-" refers to Respondents' exhibits in evidence; "J-" refers to the parties' joint exhibits; "DPS" refers to the Division's post-hearing submission; and "RPS" refers to Respondents' post-hearing submission.

[3] Respondents' post-hearing submission asserts that following the hearing, Cordovano left the Firm and assumed a position as the president of a Denver-area company. RPS at 2 n.2, 28.

Although Cordovano and Honeck were equal partners from 2002 until 2010, they did not have equal responsibilities for the operation of the Firm. Cordovano was the managing partner, and had responsibility for employment and regulatory issues, quality control, and "generally had final say on any significant transactions," while Honeck was in charge of the Firm's accounting and bookkeeping, payroll, and assisted the Firm's outside accountant in preparing the Firm's tax returns. Tr. 528, 873-74.

B. The 2008 Order

The Firm has been a registered public accounting firm since at least 2004. In 2004, the PCAOB conducted an inspection of the Firm. Thereafter, the Division began an investigation, which culminated in the 2008 Order. Tr. 529-31.

Cordovano testified that he represented the Firm and himself during the investigation, without the assistance of counsel, until shortly before the 2008 Order was issued. During this period, he engaged in settlement discussions with the Division, leading to the Division "propos[ing] a one-year timeout just for [Cordovano] alone," which Cordovano felt "would preserve the company." Before the Order was issued, however, the Firm and Cordovano retained the same experienced and knowledgeable counsel who represented them in this proceeding, and "[u]ltimately after going over [the Division's settlement proposal] with counsel, [Cordovano] decided to consent to the [2008 Order]." Tr. 531, 534-35.

Cordovano testified that in the course of his negotiations with the Division, he asked Division counsel to explain the implications of the 2008 Order in detail: "What can I do and what can't I do?" Division counsel, however, "were unwilling to advise

[him]." Tr. 536. Nevertheless, represented by counsel, Cordovano and the Firm agreed to the 2008 Order.

The 2008 Order included findings that the Firm and Cordovano violated PCAOB rules and professional standards in various respects in connection with their audits of the FY 2003 and FY 2004 financial statements of one issuer and the FY 2004 financial statements of another issuer. Based on those violations, the Board censured the Firm and barred Cordovano from being "an associated person of a registered public accounting firm, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i)," with the proviso that Cordovano could file a petition for Board consent to associate with a registered public accounting firm after one year from the date the 2008 Order was issued, which was December 18, 2008.[4] J-1 at 14. In the 2008 Order, the Board stated:

> The sanctions that the Board is imposing on Cordovano in this Order may be imposed only if a respondent's conduct meets one of the conditions set out in Section 105(c)(5) of the Act, 15 U.S.C. § 7215(c)(5). The Board finds that Cordovano's conduct described in this Order meets the condition set out in Section 105(c)(5), which provides that such sanctions may be imposed in the event of: (A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

J-1 at 2 n.2; J-2 at ¶ 3.

After the 2008 Order was issued, the Division sent Respondents' counsel a letter dated December 23, 2008. R-29; J-2 at ¶ 4. In the letter, the Division noted that Respondents had "asked the Division … for guidance regarding the effects of the sanction entered against Mr. Cordovano …." The letter explained that under the 2008 Order, Cordovano was "barred from being an associated person of a registered public

[4] The Firm was known as Cordovano and Honeck, P.C. at the time of the 2008 Order. J-2 at ¶ 1.

accounting firm, as that term is defined in Section 2(a)(9) of the [Act]," but that Cordovano could apply for Board consent to associate with a registered public accounting firm after one year. The letter stated that "the staff cannot provide legal advice or advise whether any particular future conduct by Mr. Cordovano, the Firm, or any other person would be consistent with PCAOB Rules or Standards or with a bar," but offered a general description of the provisions of Rule 5301 addressing the effects of a bar. R-29 at 1.

The letter noted that the 2008 Order did "not necessarily preclude Mr. Cordovano from continuing to be a partner in the Firm." Citing the Note to Rule 5301(a), however, the letter explained that a "person [who is] suspended or barred from being associated with a registered public accounting firm may not, in connection with the preparation or issuance of any audit report, (i) share in the profits of, or receive compensation in any other form from, any registered public accounting firm, or (ii) participate as agent on behalf of such a firm in any activity of that firm." Id. at 2 (emphasis in Division's letter).

C. Respondents' Actions in Response to the 2008 Order

Cordovano testified that, based on the Division's letter, he understood that "the order did not affect my ownership of the company. I could continue to be a partner in the company with all that[] responsibility, and what that entails." Cordovano further testified that after reading the Division's letter, he did not have a clear understanding of the specific activities that were prohibited, and therefore drew his own conclusions in that regard. He concluded that he "was barred from participating in an audit of an issuer for a one-year period." Cordovano believed that, among other things, he "couldn't prepare work papers or review them," and he "determined not to charge SEC clients for any of [his] services, whether they were in connection with an audit or not." Tr. 537-41.

Honeck testified that he was not involved in the negotiations leading to the 2008 Order, but that Cordovano told him "that he had agreed to accept the bar as part of the negotiation to try to maintain the firm's ability to continue conducting public company audits." He testified that he and Cordovano "had a general understanding that Mr. Cordovano was not to be involved in audits of public clients, but we didn't—we weren't really sure how the details of that sanction applied." Nevertheless, he testified that he understood that Cordovano "could not be involved in the audits of public companies and that Cordovano "should not be instructing the staff if it was related to performing a public company audit." Tr. 877-78, 882, 906, 931.[5]

Honeck testified that the Firm held a general meeting of the Firm's staff to discuss the impact of the bar. Tr. 884. Zhou, however, testified that she was not aware of any such meeting, and Cordovano agreed, testifying that, instead, he "told each staff member [of the Firm] at the time and place of [his] choosing about the bar." Tr. 38, 556. In any event, it was undisputed that the Firm did not establish any written polices or directives concerning compliance with the bar. Tr. 39, 920; D-114 at 6.

"As their primary response to the bar, Respondents hired Heather Zhou to handle Mr. Cordovano's public company clients." RPS at 1. Zhou was born and educated in China. She moved to the United States in 2000, and studied at the University of Denver, where she received a masters degree in accounting in 2002 and a masters degree in finance in 2005. She passed her Colorado CPA examination in 2002, and obtained her CPA license after she received her accounting degree. Tr. 23-25.

[5] Both Cordovano and Honeck indicated that Respondents may have consulted their counsel regarding the scope of the bar, but neither witness described any advice they received, and Respondents did not assert reliance on advice of counsel as either a defense to the charges or in mitigation of sanctions. Tr. 852, 882. See, e.g., Leslie A. Arouh, Exch. Act Rel. No. 62898, 2010 SEC LEXIS 2977, at *52 (Sept. 13, 2010). Apart from the Division's letter and any unspecified advice Respondents may have received from counsel, Cordovano testified that he did not seek advice from any other source regarding the scope of the bar.

From 2002 until she joined the Firm in October 2008, Zhou held a series of jobs in which she worked as an in-house accountant for various businesses. Prior to joining the Firm, Zhou had never served as an auditor, at any level of responsibility, on an audit of an issuer. Indeed, although she had worked with outside auditors in one of her in-house positions, there is no evidence that she had ever been an independent auditor, at any level of responsibility, on an audit of any type of entity, public or private, prior to her employment with the Firm. Tr. 25-26, 30, 980.

The Firm hired Zhou as a senior manager while Cordovano was negotiating with the Division, but before the 2008 Order was issued. Zhou testified that the Firm initially offered her a senior accountant position, but she negotiated a senior manager position. Both Cordovano and Honeck, however, testified that when the Firm hired Zhou, they anticipated that she would function as an engagement partner on audits of issuers after the 2008 Order became effective. Tr. 28, 549-50, 980-81.

The Firm promoted Zhou to the position of non-equity engagement partner in January 2009. Zhou testified that she was concerned about her ability to function as an engagement partner when she was promoted, but Cordovano told her that he would train her. After promoting Zhou, the Firm assigned her to be the engagement partner for the Firm's audits of the 2008 financial statements of several issuers, including three of the four audits at issue in this proceeding. Zhou replaced Cordovano as the engagement partner for all three audits. Tr. 34, 36, 551, 898.

D. The Audits at Issue

The OIP alleges that Cordovano was an associated person of the Firm because he engaged in certain specified activities in connection with the Firm's audits of the FY

2008 financial statements of four issuers: China Solar & Clean Energy Solutions, Inc. (China Solar), Playlogic Entertainment, Inc. (Playlogic), ICOP Digital, Inc. (ICOP), and Tombstone Technologies, Inc. (Tombstone).

1. The China Solar Audit

At the relevant time, China Solar was a China-based manufacturer and distributer of heating devices, and was an issuer, as defined in Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii). On April 15, 2009, the Firm issued an audit report expressing an unqualified opinion on China Solar's FY 2008 financial statements that was included in China Solar's Form 10-K filed with the SEC. J-2 at ¶¶ 25-27.

The OIP alleges: "Cordovano participated in substantive audit decisions in connection with the preparation and issuance of the Firm's audit report for China Solar in the following ways:

a. Cordovano analyzed equity purchase agreements involving China Solar, and researched how China Solar should appropriately record the equity purchases in the Company's 2008 financial statements;

b. Cordovano relayed his analysis on the proper accounting treatment for the equity purchase agreements to Firm staff working on the China Solar audit, upon which [F]irm staff relied in performing audit procedures; and

c. Cordovano provided guidance to Firm staff on the identification and disclosure of a material weakness in China Solar's internal controls over financial reporting." OIP ¶ 14.

Cordovano had been the engagement partner for the Firm's audit of China Solar's FY 2007 financial statements, prior to the issuance of the 2008 Order. J-2 at 5. He testified that one of the reasons the Firm hired Zhou was the hope that she would be of assistance to the Firm in developing its auditing practice for issuers located in China. In December 2008, Cordovano and Zhou traveled to China, in part to introduce Zhou to the management of China Solar and the members of a Chinese accounting firm with which the Firm had a business relationship. Tr. 31-33.

In January 2009, Zhou was assigned to serve as the Firm's engagement partner for the audit of China Solar's FY 2008 financial statements. J-2 at ¶ 6. In February 2009, Zhou traveled to China to oversee the audit field work, which was performed with the assistance of accountants from a Chinese accounting firm, working under her direction. Tr. 62, 182. During the field work, she sought Cordovano's input on two issues.

The first issue concerned China Solar's accounting for an acquisition during 2008—specifically, whether the acquired company's financial statements could be consolidated into China Solar's financial statements. Tr. 63-68. On February 27, 2009, Zhou sent Cordovano an email with an attached memo concerning that issue. Tr. 183; D-14 at 2.[6] On the same day, Cordovano responded with an email in which he indicated that he would "analyze the equity purchase agreements" to determine the appropriate accounting treatment. Cordovano attached to his email "an analysis of a similar issue" that he had prepared for another Firm issuer client, prior to the bar. He stated that he would "use a similar format (clause-by-clause comparison of agreements with [Emerging Issues Task Force (EITF) Issue No.] 96-16),"[7] and asserted: "If it turns out that [China Solar] does not control [the subsidiary], the agreements will need to be amended." D-14

[6] The Division's exhibit D-14 includes the text of Zhou's February 27, 2009, email to Cordovano, which refers to an attached memo regarding the acquisition issue, but not the memo itself.

[7] EITF Issue No. 96-16 addresses "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights."

at 1, 3-7. On the following day, February 28, Cordovano sent Zhou another email confirming that he planned "to compare the acquisition agreements with EITF 96-16, to ensure that [China Solar] is able to consolidate under [generally accepted accounting principles (GAAP)]." D-16 at 2.

Zhou testified that she recalled Cordovano preparing a checklist "with different questions related to the consolidation, the acquisition," the purpose of which was to determine if "China Solar [had] control of the subsidiary and [could] consolidate this subsidiary into the financial statements of China Solar." Tr. 68. No such checklist was offered in evidence, however, and Cordovano testified that he did not perform an analysis of China Solar's equity purchase agreements, because he realized that "[s]uch an analysis might call into question my agreement with the [B]oard, my signature on the bar." Tr. 663. He indicated that after he sent the February 27 email, in which he stated he would perform such an analysis, he reconsidered, and decided not to so, testifying: "I ... didn't want to have any problems with my bar .... I didn't think it was appropriate. Even though I first said I would do it." Tr. 827-28, 831.

Nevertheless, Cordovano testified, he thought it was appropriate to send Zhou the analysis that he had performed for another Firm client, reasoning that China Solar's acquisition occurred while he was the Firm's engagement partner for China Solar; that "surely I had a duty to explain this information to Ms. Zhou since she was new"; and that he was "simply sending her a document from our library that she may or may not have been aware that [w]e had." Tr. 663, 665. During his investigative testimony, however, Cordovano offered a somewhat different explanation, asserting that he "felt that [Zhou] needed my help on this particular issue," and explaining: "So I am gently—as I did with all my people, I gently led them down the path here." D-114 at 14-15.

I conclude that Zhou's testimony alone, without any supporting documentation, is insufficient to prove by a preponderance of the evidence that Cordovano followed through on his promise to analyze whether China Solar could consolidate the acquired firm's financial statements in conformity with GAAP.[8] On the other hand, I find that the Division did prove by a preponderance of the evidence that Cordovano received a request from Zhou for assistance in analyzing China Solar's agreements; determined that the issue was similar to one he had analyzed for another client before the bar; and sent that analysis to Zhou, explaining that it would be necessary to conduct a similar analysis under EITF to determine if China Solar could consolidate the subsidiary's financial statements, and what would be required if the analysis showed that China Solar did not have the required control over the subsidiary. To that degree, the evidence sustained the OIP's allegations that "Cordovano analyzed equity purchase agreements involving China Solar, and researched how China Solar should appropriately record the equity purchases in the company's 2008 financial statements" and that he "relayed his analysis on the proper accounting treatment for the equity purchase agreements to Firm staff working on the China Solar audit." OIP ¶ 14.

The second issue that Zhou raised with Cordovano in her February 27, 2009, email was her belief that China Solar had failed to comply with a Chinese regulatory

[8] I reject, however, Cordovano's testimony that he did not perform the analysis because he concluded that it might violate the bar. In his February 27 email he not only sent Zhou his prior analysis, but also promised to perform a detailed "clause-by-clause comparison of [China Solar's] agreements with EITF 96-16," and he repeated his promise to perform such an analysis in another email on the following day. D-14 at 1; D-16 at 2. If Cordovano did not actually perform the analysis, it was because China Solar subsequently decided to rescind the acquisition transaction, so that, as Cordovano admitted, "ultimately [the accounting issue] did not go anywhere." Tr. 831-32; see also D-114 at 15.

requirement in connection with the acquisition. Tr. 68-73. In his February 27 email response to Zhou, Cordovano stated:

> We have a responsibility to report to the [China Solar] Board instances of noncompliance with laws and regulations. We will have to decide whether such noncompliance is "a significant deficiency" or "a material weakness." Also, we should consider giving the client a reasonable period of time to correct the noncompliance, if one continues to exist. I can't tell from your memo if the noncompliance is serious or just a formality. At some point the lawyers should be brought into the matter, as we lack the legal background to assess non-compliance with laws-but not quite yet.

D-14 at 1, 2.

In an email dated February 28, Zhou responded to Cordovano, expressing her view that "the noncompliance is 'a material weakness,'" and explaining the reasons for her conclusion in that regard. D-16 at 3. On the same date, Cordovano replied to Zhou, advising her that the noncompliance issue "contains two distinct questions": (1) whether China Solar's management "agree[d] that the legal formalities [had] not been followed"; and (2) "[w]hat is our responsibility in a situation where we discover that [China Solar] has not complied with the terms of the acquisition agreement nor with China law?" With regard to the second question, Cordovano offered a definitive answer: "[W]e are to inform the Board. If the Board does nothing, then we are to resign." Cordovano tempered this answer, however, by noting that "we normally would discuss the matter with [China Solar's] lawyers before informing the Board, as we are not experts in these matters." He instructed Zhou to "discuss this matter thoroughly" with China Solar's management before returning to the United States, and to "be prepared to discuss the matter (and present evidence) to the lawyers" after her return. D-16 at 2.

On March 2, 2009, Zhou sent Cordovano an email in which she reported that she had discussed the issue with China Solar's CEO, who "agree[d] that the legal formalities

[had] not been followed." The CEO indicated that it would be difficult, if not impossible, to obtain the required approvals, and that he viewed the acquisition as "not a good deal," and wanted to "pull out." She reported that she would be meeting with China Solar's management and its new attorneys to discuss how to address the noncompliance issue, "mostly to move back from the acquisition." D-16 at 1-2. Cordovano responded on the same day with an email in which he praised Zhou for a "superb job"; observed that "the lawyers may propose a 'rescission' of the acquisition agreement"; and explained that, if a rescission occurred, "we must consult to determine how [China Solar] should account for it and report it," listing a series of questions relevant to that issue. D-16 at 1.

Respondents "acknowledge that Cordovano agreed with Zhou's analysis that the issue should be disclosed as a material weakness." They assert, however, that "Zhou's decision came first. Her testimony is that she made the decision, then communicated it to Cordovano at which point he agreed." RPS at 21.

Cordovano, however, did not simply agree with Zhou's material weakness conclusion. He analyzed the noncompliance issue for her, told her what the Firm's obligations were as China Solar's auditor, and directed her to consult with China Solar's management regarding the issue. And when Zhou advised Cordovano that China Solar wanted to back out of the acquisition, once again he analyzed and explained the issue and the Firm's obligations as China Solar's auditor. All of his communications with Zhou addressed what "we" should or must do, and were instructive, rather than advisory, in tone. I find, therefore, that the Division proved by a preponderance of the evidence that Cordovano "provided guidance to Firm staff on the identification and disclosure of a material weakness in China Solar's internal controls over financial reporting," as alleged in the OIP. OIP ¶ 14.

The OIP also alleges: "In July 2009, as a result of a Board inspection of the Firm's China Solar audit, the Firm became aware of certain audit procedures that had not been performed during the China Solar audit. Cordovano supervised Firm staff in their performance of these omitted audit procedures. The Firm billed China Solar for Cordovano's time supervising the performance of these procedures." OIP ¶ 15.

The parties stipulated that in June 2009, the PCAOB's Division of Registration and Inspections conducted an inspection of the Firm, focusing on six Firm audits, including the China Solar audit, and that, as a result of the inspection, the Firm became aware of certain audit procedures that had not been performed during the China Solar audit. J-2 at ¶¶ 8, 30.

In his direct testimony at the hearing, Cordovano did not address the allegation that he "supervised Firm staff in their performance of … omitted audit procedures." During his investigative testimony, however, Cordovano testified that "the PCAOB inspection showed … that our firm had omitted some procedures on the China Solar engagement. And I was responsible for complying with the PCAOB inspection. And I worked closely with the inspectors. And so I took it upon myself as not a violation of my bar to make sure that those omitted procedures got done." He explained that the omitted procedures included "five procedures related to percentage completion, auditing the even-and-even valuation, the pre-acquisition contingency accounting or auditing. … And … the impairment test on … the goodwill." When asked "did you in fact … supervise omitted procedures," Cordovano initially testified, "I did, yes," but subsequently stated: "I didn't supervise. I'm making sure that these procedures get done." The Firm's billing records indicate that Cordovano recorded time spent on this work, but that the Firm wrote off his time as "training." D-114 at 15-16, 18-19.

The distinction that Cordovano attempted to draw, during his investigative testimony, between supervising the performance of the procedures and "making sure that these procedures get done" is not meaningful. I find, therefore, that the Division proved by a preponderance of the evidence that Cordovano supervised Firm staff in their performance of omitted audit procedures, as alleged in the OIP. On the other hand, the Division failed to prove that the Firm billed China Solar for Cordovano's work; on the contrary, the Division concedes in its post-hearing submission that the Firm wrote off Cordovano's time. DPS at 9.

Finally, the OIP alleges: "In June and July 2009, Cordovano participated in and supervised the performance of procedures related to the Firm's issuance of a consent to include its previously issued audit opinion in a registration statement in a Form S-1 filing by China Solar pursuant to the Securities Act of 1933 in connection with the sale of securities by its security holders." OIP ¶ 16.

In June 2009, after the issuance of the Firm's audit report on China Solar's 2008 financial statements, China Solar requested that the Firm provide a "consent to file" the audit report in connection with China Solar's filing of an S-1 registration statement. Zhou advised China Solar that in order to provide such a consent, the Firm would have to perform some additional procedures. A debate ensued between China Solar's management and Zhou, on behalf of the Firm, as to whether it was necessary and appropriate for the Firm to perform the additional work. On June 18, 2009, apparently frustrated by Zhou's insistence that the additional work was required and the failure of the Firm to provide the requested consent, China Solar's management sent an email to Cordovano seeking his intervention. Tr. 74-84; D-57.

On June 16, 2009, shortly before China Solar contacted Cordovano, Zhou sent a memorandum to Cordovano "request[ing] [her] resignation as lead partner in this client, effective immediately." In her memorandum, Zhou stated that she "realized that the risks associated with this client require the involvement of an equity partner of [the Firm]," and that she "would like to work as a manager for this client ...." D-116. Consistent with this memorandum, Zhou testified that her role with regard to the requested consent was that of "accounting manager," and that her "understanding was that [Cordovano] led the work." Tr. 75.

Zhou testified that, after Cordovano received the email from China Solar, he discussed the issue with her and confirmed that the Firm required updated financial information from China Solar in order to provide the requested consent. On June 22, 2009, Cordovano sent an email to China Solar's CEO in which, inter alia, he advised the client that "[u]nder the provisions of Section 11 of the Securities Exchange Act, our Firm is charged with making a reasonable investigation up to the effective date of the registration statement as to whether the audited financial data to which the report relates contains any untrue statement of material fact or omits to state a material fact necessary in order to make the data not misleading." Cordovano attached the Firm's "Post Audit Review Procedures" and stated that he and Zhou would be happy to discuss the procedures with China Solar and its counsel. Notably, although Cordovano admitted that he composed and sent the email, he closed the email: "Sincerely, Cole Honeck." At the hearing, he could not explain why he had signed Honeck's name to the email, indicating that it appeared to be a mistake. D-61; Tr. 80, 83-85, 672.

Respondents argue that Cordovano merely instructed Zhou to "manage the engagement so the consent is handled promptly and professionally"; reminded Zhou that she was "responsible for managing all aspects of the [China Solar] account"; and directed her to "consult with the partner in charge," who, Respondents assert, was Honeck. RPS at 23, quoting D-73.

The exhibit cited by Respondents, D-73, contains an exchange of emails between Cordovano and Zhou on July 13, 2009, concerning the Firm's procedures in connection with China Solar's Form S-1 consent request. As indicated above, by that date Zhou had resigned as the engagement partner for China Solar and was serving as the manager. According to the email exchange, Honeck had replaced Zhou as engagement partner. The July 13 email exchange, however, occurred after Cordovano's June 22 email to China Solar's CEO discussed above, and it does not obviate Cordovano's intervention in the Form S-1 consent issue as reflected in the June 22 email. Indeed, the July 13 email exchange shows Cordovano's continued involvement in the issuance of the consent.

I find, therefore, that the Division also proved by preponderance of the evidence that Cordovano participated in and supervised the performance of the Firm's procedures in connection with China Solar's request for consent to include the Firm's previously issued audit opinion in its Form S-1 filing, as alleged in the OIP.

2. The Playlogic Audit

Playlogic was a Netherlands-based publisher of video game software and other digital entertainment products. It was an issuer, as defined in Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii). On March 31, 2009, the Firm issued an audit report expressing an unqualified opinion on Playlogic's FY 2008 financial statements that was included in Playlogic's Form 10-K filed with the SEC. J-2 at ¶¶ 31-33.

The OIP alleges: "The Firm, through Cordovano, assigned the Non-Equity Partner to serve as the partner with final responsibility on the audit of Playlogic's 2008 financial statements. During the audit's initial stages, however, the Non-Equity Partner informed Cordovano that workload conflicts on other engagements prevented the completion of the engagement partner responsibilities on the Playlogic audit. Thereafter, with Cordovano's agreement, the Non-Equity Partner did not work on the Playlogic audit." OIP ¶ 17.

The OIP further alleges: "Instead of assigning another person to serve as the partner with final responsibility for the Playlogic 2008 audit, Cordovano filled in for the Non-Equity Partner and participated in the Playlogic 2008 audit in the following manner:

a. Cordovano coordinated the Firm staff's completion of the audit;

b. Cordovano reviewed the Management Discussion and Analysis section of Playlogic's 2008 Form 10-K and communicated his corrections to Firm staff;

c. Cordovano traced the footnotes to the financial statements to other documentation; and

d. Cordovano authorized the issuance of the audit report that was included in Playlogic's Form 10-K filing with the [SEC] …."

OIP ¶ 18.

Cordovano had been the engagement partner for the Firm's audit of Playlogic's 2007 financial statements. In January 2009, Zhou was appointed to serve as the engagement partner for the Firm's audit of Playlogic's 2008 financial statements. J-2 at ¶¶ 5-6; R-4. Zhou testified, however, that "soon after [she] was assigned as engagement partner," she concluded that her workload on other audits did not allow her to serve as the engagement partner on the Playlogic audit. She testified she discussed the issue with Cordovano, who told her, "don't worry about it. He would take care of it." Tr. 49.

There is no documentary evidence directly supporting Zhou's claim that Cordovano relieved her of responsibility for the Playlogic audit. On March 3, 2009, however, Zhou sent an email to Cordovano and Honeck setting out "a preliminary schedule for my clients on hand," which did not include the Playlogic audit. Cordovano responded to Zhou's email without indicating that she had omitted the Playlogic audit from her work schedule. D-130 at 1-2; Tr. 50-51. This email exchange provides indirect support for Zhou's claim.

On the other hand, Cordovano testified that Zhou remained as the engagement partner on the Playlogic audit to its conclusion. His testimony was supported, to a degree, by Quijote-Oakes, who served as the senior manager for the Playlogic audit from her home in Ohio. She testified that she understood that Zhou was the engagement partner for the Playlogic audit. Noordeloos, Playlogic's CFO, also testified that he understood that Zhou was the engagement partner for the audit, and that Zhou did not tell him during the audit that she was no longer the engagement partner. Cordovano's testimony is also supported by various documents in evidence, including emails that Cordovano sent to Quijote-Oakes and Noordeloos near the end of the audit in which he implied that Zhou remained the engagement partner. Tr. 389, 600, 1010-11; D-24; D-36; D-37.

I do not find, therefore, that the Division proved by a preponderance of the evidence that Zhou was formally replaced as the Playlogic engagement partner during the course of the audit. The evidence did establish, however, that Quijote-Oakes, who had worked on the Firm's audits of Playlogic's 2006 and 2007 financial statements, was primarily responsibility for the Firm's audit of Playlogic's 2008 financial statements. She traveled to the Netherlands with Ginsburg to perform field work, and communicated with the local Netherlands-based accountants who assisted with the audit. Further, although Quijote-Oakes testified that she understood that Zhou was the engagement partner, she also testified that Cordovano, rather than Zhou, monitored her progress on the audit, and that she did not recall receiving any supervision from Zhou during the audit.[9] Tr. 388-90, 1004-05, 1007. Her testimony is supported by several email exchanges, described below.

On March 31, 2009, there was a series of email communications leading up to the issuance of the Firm's audit report and the filing of Playlogic's Form 10-K that day.[10] Quijote-Oakes sent an email to Cordovano and Zhou attaching "the final draft of Playlogic's financial statements," and asking: "Can you please have a staff foot the

[9] Respondents point to a March 19, 2009, "substantive" email exchange between Zhou and Quijote-Oakes as evidence that Zhou was supervising the audit as the engagement partner for the Playlogic audit as of that date. RPS at 14, citing R-7. Quijote-Oakes had sent an email to Zhou, copied to Cordovano, setting forth her accounting analysis of the manner in which Playlogic calculated the fair value of certain stock conversion rights the company had granted to lenders, and asking Zhou for her thoughts on the analysis. Zhou's one-sentence response—"Why the company has to do the calculation?"—was hardly substantive. In fact, if anything, it suggests a lack of familiarity with the accounting issues in the audit that is inconsistent with her having supervised the audit as the engagement partner.

[10] Although the email communications in evidence include a time of day for each email, as well as the date, the emails involved individuals in different time zones, and some were produced to the Division by Quijote-Oakes, who was located in Ohio, while others were produced by the Firm, which was located in Colorado. As a result, I do not find it possible to make reliable findings as to the precise sequence of emails sent on a particular date that are not contained in a single exhibit. On the other hand, where a single exhibit includes a string of emails, I find it possible to make reliable findings as to the sequence of those emails, if not the precise times at which they were sent or received.

financial statements and review the [Management Discussion and Analysis (MD&A)] section [of Playlogic's Form 10-K]?" Cordovano, not Zhou, responded with an email, on which Zhou was not copied, advising Quijote-Oakes: "Attached is the MD&A review. Please note that many corrections are needed. The footing is complete and there were no errors. It is close to filing time. I will call you in shortly to firm this up." D-111.

Cordovano also sent an email advising Quijote-Oakes that the filing agent who would file Playlogic's Form 10-K in the SEC's EDGAR filing system would be sending her a draft EDGAR filing, and stating: "I will call [the filing agent] back in 10 minutes to read the MD&A corrections to her. I will now trace the footnotes." Once again, Cordovano did not copy Zhou on the email. In a response to Cordovano's email, Quijote-Oakes advised him that Noordeloos had "one change to the last version I emailed to you and [Zhou]." Cordovano responded to Quijote-Oakes that "footnote disclosure of comprehensive [income] is not allowed. Playlogic can use: Second income statement; Combined statement of comprehensive income[; or] Statement of stockholders' equity[.]" Again, he did not copy Zhou on the email. D-35.

Cordovano also sent Quijote-Oakes an email stating: "1. I have a set of Playlogic 2008 [work papers] here. We can go over those tomorrow. I have no problem with two hard files (just the coordination)[.] 2. Let me know when you are happy with Playlogic. I will ask [Zhou] to press the button." Yet again, Cordovano did not copy Zhou on the email. D-36.

Finally, Cordovano sent Quijote-Oakes another email stating: "[Zhou] signed off." Cordovano, however, did not copy Zhou on the email, and Zhou testified that she did not authorize the Firm's audit opinion on Playlogic's 2008 financial statements, and that Cordovano did not ask her to do so. D-37; Tr. 56-57. Playlogic's 2008 Form 10-K, which included the Firm's unqualified opinion on its financial statements, was filed on March 31, 2009. J-2 at ¶ 33.

While they acknowledge that Cordovano took part in the communications described above, Respondents argue that he "was acting as a 'go-between' for Zhou and Quijote-Oakes, a role necessitated by their mutual antipathy." They assert that Cordovano "acted as an intermediary, in his role as responsible managing partner, to get the job done. His conduct did not involve, as alleged by the Division, coordinating the firm's audit ...." RPS at 15, 16.

The evidence supports Respondents' contention that Zhou and Quijote-Oakes were personally at odds. Tr. 580-82, 608, 857-58. Further, the Division did not prove by a preponderance of the evidence that Cordovano personally reviewed the MD&A section of Playlogic's 2008 Form 10-K or personally traced the footnotes in the financial statements. While Cordovano's emails can be read to suggest that he performed that work himself, Cordovano testified that he assigned the work to junior staff, and other witnesses agreed that such an assignment would have been consistent with Firm practice. Tr. 607-08, 615-17, 861.

Nevertheless, although Cordovano may not have performed the MD&A review and footnote tracing himself, at a minimum he coordinated that work, as alleged in the OIP. Moreover, the emails show that Cordovano advised Playlogic, through Quijote-Oakes, regarding the appropriate manner to disclose comprehensive income; communicated with the EDGAR filing agent regarding the filing of Playlogic's 2008 Form 10-K; and instructed Quijote-Oakes regarding the work papers for the audit and expressed his intention to review them with her. All of those actions also substantiate the OIP's allegation that Cordovano coordinated the Firm staff's completion of the audit.

I also find that the Division proved by a preponderance of the evidence that Cordovano, rather than Zhou, authorized the issuance of the Firm's audit report. Although Cordovano's emails to Quijote-Oakes indicate that Zhou "signed off" on the Playlogic audit, Zhou denied that she authorized the Firm's audit report, and I found her testimony in that regard credible.

Respondents argue: "Common sense dictates that Zhou was at all times the engagement partner for Playlogic, and her denial of this fact is driven more by her desire to evade responsibility [for the audit] than any reality." RPS at 16. Respondents rest this argument on testimony that Zhou was upset by the PCAOB inspectors' critical comments on the Playlogic audit. R-22A at 11-14. The inspectors also made critical comments regarding the China Solar and ICOP audits, however, yet Zhou has never denied serving as the engagement partner for those audits. Id. at 1-10.[11]

Although Cordovano claims that Zhou approved the issuance of the Firm's Playlogic audit report, I find it significant that he did not copy Zhou on his emails to Quijote-Oakes in which he indicated that that he would ask Zhou to "press the button" and that she had signed off. Moreover, the Firm's records do not reflect Zhou's approval of the audit. During the PCAOB's inspection of the Firm in June 2009, the inspectors

[11] Respondents also argue that "[t]he circumstances of Zhou's termination also call her motivations into question." RPS at 16 n.10. When the Firm terminated Zhou's employment, it withheld $2,100 from her final paycheck to pay for services by the Firm's counsel that the Firm contended were personal to Zhou and unauthorized. On the evening of her termination, Zhou contacted the PCAOB and she later contacted several of the Firm's clients. She testified that ultimately she was able to obtain a portion of the amount the Firm had withheld after she filed a complaint with the Department of Labor. Tr. 158-63, 238-39, 242-44. The evidence indicates that Zhou was angry with Respondents at the time of her termination, but at the hearing her demeanor did not indicate any continuing hostility toward Respondents. I credit her testimony that she did not sign off on the Playlogic audit both because her demeanor indicated that her testimony was truthful, and because her testimony is supported by the documentary evidence.

selected the Playlogic audit for review. The Firm's records provided to the auditors reflected Honeck's electronic signature as the "lead audit partner" for the audit, with a date of June 6, 2009, and Zhou's electronic signature as the "concurring audit partner," with a date of June 8, 2009. D-3.

Zhou acknowledged that, as reflected in the Firm's records, she approved the Firm's Playlogic audit as the concurring partner. Tr. 157. Since she could not have served as both the engagement partner and the concurring partner, the Firm's records are consistent with Zhou's testimony, and inconsistent with Cordovano's testimony that Zhou signed off on the Firm's audit report on March 31, 2009, as the engagement partner. Further, it was apparent from Zhou's testimony that she took her responsibilities as an auditor very seriously. Therefore, I find that if Zhou had believed that she was responsible for the issuance of the Firm's audit report on Playlogic, she would have entered her signature on the work papers on or about March 31, 2009, reflecting that capacity. Similarly, she would not have certified that she performed a concurring review if she had approved the Firm's Playlogic audit report as the engagement partner.

Honeck testified that "[e]arly on in the inspection process" Zhou told him that "if the PCAOB inspectors asked her any questions regarding Play Logic [sic], she was going to state that she was not the engagement partner for the Play Logic engagement." He also admitted that when Zhou made that statement, she "may have" told him that "one reason for ... not wanting to be engagement partner was because, according to her, Mr. Cordovano's level of involvement in the Play Logic [sic] engagement was greater than hers." Honeck also admitted that Zhou also "may have" told him that "she did not feel she want[ed] to act as lead engagement partner because the majority of the work was conducted by Ms. Quijote-Oakes, and Mr. Cordovano was involved in that engagement, somehow taking over her role." Further, although the Firm's records indicate that Honeck signed off on the audit as lead partner, Honeck testified that he did not place or authorize his signature on the audit, and that he did not know who placed his name in the Firm's records indicating his sign-off on the audit. Tr. 894, 955, 959.

Accordingly, I reject Respondents' arguments that Zhou functioned "at all times" as the engagement partner on the Playlogic audit. Instead, I find that the Division proved by a preponderance of the evidence that Cordovano authorized the issuance of the Firm's Playlogic audit report on March 31, 2009.[12]

3. The ICOP Audit

ICOP, headquartered in Kansas, designed, engineered and marketed video surveillance products for public safety. It was an issuer, as defined in Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii). On March 20, 2009, the Firm issued an audit report expressing an unqualified opinion on ICOP's FY 2008 financial statements that was included in ICOP's Form 10-K filed with the SEC. J-2 at ¶¶ 38-40.

[12] Respondents argue that Zhou's participation in a meeting with Playlogic's audit committee in April 2009, and her charging time to prepare for the meeting, as reflected in the Firm's billing records, contradicts her testimony that she was not the engagement partner on the audit. Playlogic had attempted, without success, to schedule a telephonic meeting of Playlogic's audit committee prior to the issuance of the Firm's audit report and the filing of Playlogic's Form 10-K on March 31, and Cordovano had advised Noordeloos that Zhou and Quijote-Oakes would report the results of the audit to the audit committee during the meeting, on behalf of the Firm, in light of his bar. D-24; D-26; D-34. On April 1, 2009, however, Quijote-Oakes resigned from the Firm. D-38. Noordeloos testified that the audit committee meeting eventually took place on April 22, 2009, and that Zhou took the lead in explaining the Firm's audit to the audit committee. Tr. 1007-09, 1036-37. In addition, the Firm's billing records show that during the period April 20-22, 2009, Zhou billed 8.5 hours for preparation for the Playlogic audit committee meeting, including reviewing work papers, and studying "software development costs, amortization and impairment related GAAP issues." R-12. Respondents argue that this work was "consistent with the duties of an engagement partner." RPS at 14. Zhou, on the other hand, testified that after Quijote-Oakes resigned, Cordovano asked her to help with the Playlogic engagement, and therefore she expended time reviewing the audit work papers in order to understand the audit work that had been performed. Tr. 207-11. Zhou's participation in the audit committee meeting, and the work she billed for preparing for the hearing, in light of Quijote-Oakes departure, is not inconsistent with her testimony that Cordovano had relieved her of responsibility as engagement partner. More importantly, it does not outweigh the evidence indicating that on March 31, 2009, Cordovano, rather than Zhou, approved the issuance of the Firm's audit report.

The OIP alleges: "Cordovano participated in the Firm's audit of ICOP in the following manner:

a. Cordovano advised Firm staff on the appropriate accounting treatments to be applied by ICOP to the modifications of options and to scrap inventory; Firm staff relied on Cordovano's guidance in issuing the Firm's audit report.

b. Cordovano coordinated and evaluated the concurring review. On March 19, 2009, the concurring review partner assigned to the ICOP audit provided Cordovano with comments on the draft ICOP 2008 financial statements. Cordovano reviewed the comments and directed Firm staff to address the comments. On March 21, 2009, Cordovano learned that the Firm had issued the ICOP audit report without the concurring review having been completed. Upon learning this, Cordovano led a meeting with the concurring review partner, the Non-Equity Partner, and the Firm Equity Partner, at which it was agreed that the concurring review would be completed as soon as feasible.

c. The Firm billed ICOP for a portion of Cordovano's time working on the audit of ICOP's 2008 financial statements. Specifically, with Cordovano's knowledge, the Firm billed ICOP $900 on its March 3, 2009 invoice, $2,200 on its June 18, 2009 invoice, and $600 on its July 10, 2009 invoice for Cordovano's services." OIP ¶ 20.

Cordovano had been the engagement partner for the Firm's audit of ICOP's 2007 financial statements. In January 2009, Zhou was appointed to serve as the engagement partner for the Firm's audit of ICOP's 2008 financial statements. Quijote-Oakes was the manager for the audit and Ginsburg was a junior auditor. J-2 at ¶¶ 5-6; Tr. 97, 857. During the audit, Cordovano was consulted about several ICOP accounting issues.

On March 10, 2009, Cordovano sent an email to Quijote-Oakes directing her to send him "a draft of the ICOP Form 10-K." D-103. Quijote-Oakes testified that she was "[p]retty sure" she complied with Cordovano's direction. Tr. 425. On the following day, March 11, Quijote-Oakes sent an email to Zhou, Cordovano, Ginsburg, and Koslofsky, ICOP's CFO, indicating that Koslofsky would be making several changes to ICOP's financial statements. Cordovano responded to Quijote-Oakes' email, copying Zhou, and stated: "In accordance with a memo from [ICOP's former CFO] last year, ICOP should have been amortizing the cost of [its] scrap inventory over a relatively short period of time. Please see [the former CFO's] memo. You may have a change in accounting estimate." D-18. Quijote-Oakes testified that ICOP had not been amortizing the cost of its scrap inventory, and that doing so, in accordance with Cordovano's email, would have resulted in a change in an accounting estimate that would have affected ICOP's financial statements. Tr. 428-29.

On March 12, 2009, Quijote-Oakes sent an email to Koslofsky, and others (including Zhou, but not Cordovano), in which she stated that "[a]fter discussion with the partners, we believe that the Company has two options on how to account for scrap inventory that [the Firm] can live with," and listed the two possible accounting treatments, one of which was to amortize the cost of the scrap inventory in accordance with the former CFO's memo. D-104. Quijote-Oakes testified that she believed that the phrase "discussion with the partners" in her email referred to a telephone conversation she had with Zhou and Cordovano regarding the issue. Tr. 430. In his testimony, Cordovano asserted that he provided information regarding the proper accounting treatment for ICOP's scrap inventory "[b]ecause I had knowledge of this from my time as the partner [for] ICOP and I owed it to the company, not to mention the stakeholders in the company, to make sure that their financial statements were correct." Tr. 643.

Cordovano also provided advice regarding ICOP's accounting treatment for the modification of stock options. On February 24, 2009, Cordovano sent Quijote-Oakes an email in which he incorporated material that he had copied from an unidentified publication in the Firm's research files providing advice regarding the proper accounting for "Modification of Vested Share Options," and advised Quijote-Oakes: "I think illustration 13 may apply." On February 27, 2009, Quijote-Oakes sent an email to Cordovano in which she stated: "With [Koslofsky's] and your input, I believe we've determine[d] the answer to the issue relating to the unvested stock awards based on the guidance under Illustration 13c [in the materials that Cordovano had sent]." She attached an "updated analysis for your review" which cited Illustration 13c in the materials that Cordovano had sent as support for the accounting treatment. D-100; Tr. 422-24.

In his testimony, Cordovano asserted that he sent the material to Quijote-Oakes because "[s]he asked me about this issue," and, working from her home in Ohio, did not have access to the Firm's research files. Cordovano testified that he did not believe providing the material to Quijote-Oakes contravened the bar:

> Because this issue was one that I was intimately familiar with when I was the engagement partner on it. So I was once again transferring to [Zhou] my knowledge, which was required under—which was in accordance with the partnership rotation standards.

Tr. 639.

Cordovano also arranged for Fleischman, who was a partner in another Denver-area registered public accounting firm, to serve as the concurring review partner for the ICOP audit. Fleischman testified that he understood that Cordovano contacted the senior partner in his firm seeking a concurring review partner; Cordovano testified that it was Fleischman's senior partner who approached him, seeking the work. In either case, on March 19, 2009, Cordovano discussed the matter with Fleischman and the senior partner and on behalf of the Firm retained Fleischman to serve as the concurring review partner for the ICOP audit. Tr. 261-62, 623-24; J-2 at ¶ 42.

Also on March 19, Cordovano sent Fleischman an email attaching "the latest draft of the financials," and advising Fleischman: "We have identified the high-risk areas. The files are ready for your concurring review." Cordovano did not copy Zhou, the engagement partner, on the email. On the same date, Fleischman sent Cordovano comments on ICOP's draft financial statements. Cordovano reviewed Fleischman's comments and directed Quijote-Oakes to address them. J-2 at ¶¶ 43-44; D-22; D-23A; R-8; Tr. 262-66.

On March 21, 2009, Fleischman went to the Firm's offices to review the ICOP work papers, and met with Zhou and Quijote-Oakes (who participated by telephone). During the meeting, Fleischman learned that ICOP's Form 10-K, which included the Firm's audit report on ICOP's financial statements, had been filed with the SEC the previous day, before his concurring review was completed. Tr. 118-20, 266-69. Cordovano and Honeck, who were in the office that day, also learned that the Form 10-K had been filed before the concurring review was completed, and they took part in a meeting, along with Zhou and Fleischman to discuss the problem. Honeck admitted that

Cordovano took charge at that point and made the decisions for the Firm about how to deal with the issue.[13] J-2 at ¶¶ 45-46; Tr. 963-65.

Finally, the parties stipulated that:

> The Firm billed ICOP for a portion of Cordovano's time, as follows: $900 for a post-audit review of its financial statements included in ICOP's registration statement on Form S-1 on its March 3, 2009 invoice, $2,200 for a "comfort letter" to ICOP's underwriter on its June 18, 2009 invoice, and $600 on its July 10, 2009 invoice for Cordovano services for another such letter.

J-2 at ¶ 47; see also D-17; D-53; and D-72 (related invoices). Cordovano testified that at least the first stipulated billing was a mistake and that he did not know how it occurred, but offered no further explanation for the billings to ICOP. Tr. 640-41. Zhou testified that Cordovano reviewed all the Firm's billings for the ICOP audit, and decided what to charge the client, even though she served as the engagement partner. Tr. 104-05.

I find, therefore, that the Division proved by a preponderance of the evidence that: (1) Cordovano advised Firm staff on the appropriate accounting treatments to be applied by ICOP to the modifications of options and to scrap inventory, and Firm staff relied on his guidance; (2) Cordovano coordinated and evaluated the concurring review for the ICOP audit in the specific respects set forth above; and (3) the Firm billed ICOP for Cordovano's time as stipulated by the parties, all as alleged in the OIP. OIP ¶ 20.

[13] In their post-hearing submission, Respondents, citing testimony by Fleischman, appear to contend that Fleishman did not participate in the meeting. RPS at 19, citing Tr. 267-68, 305. Respondents, however, stipulated that Fleishman attended the meeting, and I find Fleischman's equivocal testimony insufficient to negate the stipulation. In any event, whether Fleischman participated is immaterial; the relevant evidence concerns Cordovano's involvement.

At the hearing, Honeck initially testified that he did not recall that Cordovano made the decisions about how to deal with the filing of ICOP's Form 10-K before the concurring review was completed. When shown testimony he gave during the investigation, however, Honeck agreed that Cordovano "took charge and made the decisions on how to deal with this issue." Tr. 962-63.

4. The Tombstone Audit

Tombstone, based in Colorado, manufactured and marketed custom playing cards. It was an issuer, as defined in Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii). On March 31, 2009, the Firm issued an audit report expressing an unqualified opinion on Tombstone's FY 2008 financial statements that was included in Tombstone's Form 10-K filed with the SEC. J-2 at ¶¶ 48-50.

The OIP alleges: "Cordovano participated in the Firm's audit of Tombstone's 2008 financial statements in the following manner:

a. Cordovano coordinated the performance of the Firm's fieldwork for the audit;

b. Cordovano directed Tombstone to prepare its books and other information for the Firm's audit engagement team to review; and

c. Cordovano coordinated the Firm's review of Tombstone's 2008 financial statements."

OIP ¶ 22.

Cordovano was the Firm's engagement partner for Tombstone's audits prior to the audit of its 2008 financial statements. In January 2009, responsibility for that audit was assigned to Honeck. Cordovano, however, had a long-standing relationship with Tombstone's CFO, and continued to communicate with the CFO regarding the 2008 audit even after Honeck became the engagement partner. Tr. 801-02, 939, 945-46.

On January 8, 2009, after the bar had become effective, Cordovano sent an email to Tombstone's CFO stating: "Tombstone is scheduled for January 19-22. Please have the books to us by Friday January 16." He did not copy Honeck on the email. D-7.

On March 10, 2009, Tombstone's CFO sent an email to Cordovano asking for "a quick update." Cordovano responded on the same date stating: "We will conclude our fieldwork once you provide the following documents or answer the following questions," with a list of the required documents, and advised the CFO to "call if you have any questions." Cordovano copied Melody Song, a junior Firm staff member who was working on the audit, on the email, but not Honeck. D-92.

On March 19, 2009, Cordovano sent an email message to Tombstone's attorney stating: "We have reviewed Tombstone's financial statements and have made certain revisions. Please draft the final version for our final review." On the same day, Tombstone's CFO responded to Cordovano's email, asking why the revised document "does not look like all the other ones we have submitted to the SEC." Cordovano responded on the same day, explaining that "the revenues, cost of sales and a portion of salaries, for each year, are lumped together in 'discontinued operations.' We want to keep the playing card component (discontinued operations) segregated from the software component (continuing operations) because that presentation is considered more useful to investors." Cordovano did not copy Honeck on his emails. D-21; Tr. 803-06.

On March 27, 2009, Cordovano sent another email to Tombstone's CFO stating: "Our staff made several editorial changes to the financials and they are satisfied with the presentation and disclosure. However, [Tombstone's in-house accountant] must complete the tax footnote ... before you can file the statements. We are not allowed to draft the footnotes as it appears to impair our independence." For reasons he could not explain at the hearing, Cordovano did not copy Honeck on this email, but did copy Zhou, who was not working on the Tombstone audit. D-31; Tr. 807-09, 811, 813-14.

I find, therefore, that the Division proved by a preponderance of the evidence, that, in the manner and to the extent reflected in the emails cited above, Cordovano coordinated the performance of the Firm's fieldwork for the audit; directed Tombstone to prepare its books and other information for the Firm's audit engagement team to review; and coordinated the Firm's review of Tombstone's 2008 financial statements, as alleged in the OIP. OIP ¶ 22.

III. Discussion and Conclusions

A. Violation

Section 105(c)(7)(A) of the Act makes it "unlawful for any person that is suspended or barred from being associated with a registered public accounting firm … willfully to become or remain associated with any registered public accounting firm, or for any registered public accounting firm that knew, or, in the exercise of reasonable care should have known, of the suspension or bar, to permit such an association, without the consent of the Board or the [SEC]." Similarly, PCAOB Rule 5301(a) provides that "[n]o person that is … barred from being associated with a registered public accounting firm … may willfully become or remain associated with any registered public accounting firm, without the consent of the Board … or the [SEC]," and Rule 5301(b) provides that "[n]o registered public accounting firm that knows … of the … bar of a person may permit such person to become or remain associated with it, without the consent of the Board … or the [SEC]."

It is undisputed that during the period at issue in this proceeding, Cordovano was barred from being associated with a registered public accounting firm, and the Firm was a registered public accounting firm. Further, Respondents do not claim, and there is no evidence, that Cordovano or the Firm sought or obtained the consent of the Board or the SEC for Cordovano to associate with the Firm. Finally, it is beyond dispute that the Firm, through Cordovano and Honeck, its owners, was well aware that Cordovano was subject to a bar at the relevant time. The issue presented, therefore, is whether the facts, as set forth above, establish that Cordovano willfully became or remained associated with the Firm.

During the relevant period, Cordovano continued to be a partner and co-owner of the Firm. As the Division indicated in its December 23, 2008 letter, however, the bar did not necessarily preclude Cordovano from continuing in those roles.

The PCAOB does not exercise plenary authority over public accounting firms or their employees. Instead, under the Act, the PCAOB's authority addresses one of a number of roles filled by CPAs—the auditing of issuers. The definition of "associated person" set forth in Section 2(a)(9)(A) of the Act at the relevant time reflected the PCAOB's limited authority:[14]

> The terms "person associated with a public accounting firm" (or with a "registered public accounting firm") and "associated person of a public accounting firm" (or of a "registered public accounting firm") mean any individual proprietor, partner, shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report—
>
> (i) shares in the profits of, or receives compensation in any other form from, that firm; or
>
> (ii) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm.

[14] In July 2010, after the events at issue in this proceeding, the definition of associated person was amended by the Investor Protection and Securities Reform Act of 2010 in respects not relevant to this proceeding.

Rule 1001(p)(i) sets forth the same definition, but omits the words "or otherwise" after the phrase "participates as agent," and further, pursuant to the authority granted by Section 2(a)(9)(B) of the Act, provides that "a person engaged only in clerical or ministerial tasks or a person whom the public accounting firm reasonably believes is a person primarily associated with another registered public accounting firm" will not be deemed to be an associated person of that firm.

The OIP's allegations, and the Division's arguments, rest on the second portion of the definition—"participates as agent … on behalf of such accounting firm in any activity of that firm [in connection with the preparation or issuance of any audit report]"; the OIP does not allege, and the Division does not argue, that the first portion of the definition—"shares in the profits of, or receives compensation in any other form from, that firm [in connection with the preparation or issuance of any audit report]"—applies.

Respondents argue that the associated person definition is vague, and that they adopted a reasonable interpretation of it, under which Cordovano "focused on the Division's instructions concerning receiving compensation from audits of public companies, and participating as an agent on behalf of a public company accounting firm. … Specifically, Mr. Cordovano understood the letter to say that he (1) could not bill public clients, and (2) could not disassociate with the firm and circumvent the bar by acting as a contractor or agent." RPS at 7. Further, Respondents argue: "Logically relying on the portion of the [Division's] letter stating '[t]he Order does not necessarily preclude Mr. Cordovano from continuing to be a partner in the Firm[,]' Mr. Cordovano understood that he could continue as managing partner, with all of the ordinary managerial responsibility that the position entails." Id. at 6.

Respondents' contention that they relied on the Division's December 2008 letter is untenable. First, the Division did not give Respondents any "instructions" regarding compliance with the 2008 Order. On the contrary, the letter expressly stated that "the staff cannot provide legal advice or advise whether any particular future conduct of Mr. Cordovano ... would be consistent with PCAOB Rules or Standards or with a bar." R-29 at 1. Second, Respondents could not reasonably have interpreted the Division's statement in the letter that the bar did "not necessarily preclude Mr. Cordovano from continuing to be a partner in the Firm" (id. at 2) as indicating that Cordovano was free to participate in audits of issuers on behalf of the Firm, in spite of the bar, so long as he could relate that participation in some way to his role as the Firm's managing partner.

Similarly, Respondents' contention that they understood the word "agent" to mean simply that Cordovano could not disassociate from the Firm and participate in the Firm's audits as a contractor is both unreasonable and not credible. It is apparent from the context in which the word agent is used that it is intended to broaden, not limit, the definition of associated person, in order to ensure that it encompasses any professional who participates in an audit of an issuer on behalf of a registered public accounting firm, whether or not employed by the firm. As a partner and co-owner of the Firm, Cordovano was unquestionably acting as its agent, and it is not credible that Cordovano, an experienced accountant who acknowledged that "[a]gency was a part of my business law training in college" (Tr. 539), did not understand that he was an agent of the Firm.[15]

Further, the testimony of both Cordovano and Honeck evinced a clear understanding that the bar applied to Cordovano's activities as a partner in the Firm.

[15] Respondents have never argued that any of Cordovano's actions were ultra vires, or otherwise beyond the scope of his authority as co-owner and managing partner of the Firm, and there is no evidence in the record that would support such a contention.

Thus, Cordovano acknowledged that he knew he was "barred from participating in an audit of an issuer," and that as a result he could not "prepare work papers or review them," and he claimed that he decided not to analyze China Solar's equity purchase agreements, as he had promised Zhou, because he was concerned that such work "might call into question" his compliance with the bar and therefore he "didn't think it was appropriate." Similarly, Honeck acknowledged that he understood Cordovano "could not be involved in the audits of public companies" and "should not be instructing the staff if it was related to performing a public company audit." Tr. 537-41, 663, 827-28, 831, 906, 931.

Respondents also argue that Cordovano's activities in connection with the audits at issue did not make him an associated person. In that regard, however, the definitions in the Act and the Board's rules are comprehensive, encompassing participation in "any activity" in connection with the preparation or issuance of an audit report for an issuer. Here, as set forth above, the evidence establishes that Cordovano participated in significant activities of the Firm in connection with all four audits. Among other things, he advised Zhou on two important issues during the China Solar audit; he coordinated the completion of the Playlogic audit and authorized the issuance of the Firm's opinion; he advised the audit team on important accounting issues and, in certain respects, coordinated the concurring review during the ICOP audit; and he coordinated audit work, and gave directions to the client in that regard, during the Tombstone audit. Cordovano also supervised post-audit work related to the Firm's China Solar audit, and billed ICOP for post-audit work related to the Firm's opinion.

Respondents argue that Cordovano's activities were outside the definition of associated person because he was acting in the role of managing partner, or was sharing his knowledge as the former engagement partner for the client with the Firm's audit team, or was training junior staff assigned to the audits.[16] But the definition of associated person does not exempt any of those roles from its reach. The evidence established that Cordovano influenced the conduct of all four audits in important ways. At a minimum, he provided the frameworks for Zhou to analyze the China Solar consolidation issue and to address a material weakness in internal controls; he coordinated the completion of the Playlogic audit work, including instructing the client, through Quijote-Oakes, on the proper presentation of comprehensive income in the financial statements, and he authorized the issuance of the Firm's opinion; he influenced the audit team's assessment of ICOP's accounting for the modification of options and scrap inventory; and he coordinated Tombstone's cooperation with the Firm's audit team. It would be nonsensical to suggest that an accountant could engage in such activities without becoming an associated person.

In the context of a bar, that conclusion is even more apparent. To support a bar, the Board must find, as it did in the 2008 Order, that the barred person committed intentional or reckless violations, or repeated negligent violations, of PCAOB auditing standards or rules, or the securities laws. Permitting a person who engaged in such conduct to become as deeply involved in the audit process as Cordovano was in the China Solar, Playlogic, ICOP, and Tombstone audits would be fundamentally

[16] Respondents also argue that some of Cordovano's activities were not covered by the definition of associated person because they were merely "clerical or ministerial tasks." The exemption from the definition of associated person in Rule 1001(p)(i), however, applies to "a person engaged only in clerical or ministerial tasks," not to the tasks themselves. Cordovano's work as a partner in the Firm involved far more than clerical or ministerial tasks. As a result, the exemption does not apply.

inconsistent with the goal to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports" set forth in Section 101(a) of the Act. Plainly, a barred individual should not be advising the engagement partner or the audit manager on the proper analysis of important accounting issues, as Cordovano did in the China Solar and ICOP audits; and should not be coordinating the completion of an audit, authorizing the issuance of an audit report, or directing an issuer in connection with an audit as Cordovano did in the Playlogic and Tombstone audits. Indeed, as Honeck acknowledged, a barred individual "should not be instructing the staff if it was related to performing a public company audit" in any respect.

Respondents also argue that Cordovano's post-audit activities regarding China Solar and ICOP were not "in connection with the preparation or issuance of any audit report," and thus were not covered by the definition of associated person or the bar. The Act, however, is remedial legislation intended for the protection of investors and it is a "familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes." Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (noting that "[t]he Securities Exchange Act quite clearly falls into the category of remedial legislation"). The Board's auditing standards reflect the Board's understanding that in order to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports," the Act must reach work performed both before and after the audit itself that is related to the preparation and issuance of the audit report, and the SEC's approval of those standards indicates the SEC's concurrence in the Board's interpretation of the Act.

Accordingly, PCAOB auditing standards explicitly addressed the Firm's performance of procedures it had omitted from the China Solar audit, after the PCAOB inspection. See AU § 390, Consideration of Omitted Procedures After the Report Date. PCAOB auditing standards also addressed the Firm's work relating to the inclusion of its report in China Solar's S-1 filing, and the similar work by Cordovano for which the Firm billed ICOP. See AU § 711, Filings Under Federal Securities Statutes. Because the work was addressed by the PCAOB's auditing standards, Respondents were on notice that it was "in connection with the preparation or issuance of" the Firm's audit reports, and thus within the scope of the definition of associated person. Therefore, Respondents also had notice that the bar prohibited Cordovano from participating in any activity of the Firm in connection with that work.

I conclude, therefore, that, as a result of his participation in the Firm's activities in connection with the China Solar, Playlogic, ICOP, and Tombstone audits, as set forth above, Cordovano became or remained an associated person of the Firm. The remaining question is whether his association was willful.

Respondents argue that to establish willfulness, the Division had to prove that Cordovano acted with scienter. In support, they point to the OIP's allegation that "Cordovano's violations resulted from intentional or knowing conduct, including reckless conduct," and that "the Firm's violations resulted from intentional or knowing conduct, including reckless conduct," or, alternatively, "involved repeated instances of negligent conduct." OIP ¶¶ 28, 33-34.

Respondents' argument is without merit. "Willfulness is usually understood to be contextual. ... 'It is only in very few criminal cases that "willful" means done with a bad purpose. Generally, it means no more than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law.'" 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)).

The portions of the OIP cited by Respondents address scienter in a different context—sanctions. As discussed in greater detail below, Section 105(c)(5) of the Act provides that the PCAOB may only impose certain sanctions authorized in Section 105(c)(4) of the Act if the respondent engaged in "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or ... repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." By making scienter expressly relevant to the sanctions issue, the Act confirms that scienter is not required to establish willfulness for purposes of finding a violation. See Gately & Assocs., LLC, Exch. Act Rel. No. 62656, 2010 SEC LEXIS 2535, at *27 (Aug. 5, 2010). Accordingly, I conclude that, as in other sections of the securities laws, willfulness for purposes of Section 105(c)(7)(A) of the Act and Rule 5301 requires only that the person charged "knows what he is doing."

Based on Cordovano's own testimony, it is beyond dispute that he knew what he was doing when he engaged in the activities in connection with the China Solar, Playlogic, ICOP, and Tombstone audits described above. Therefore, his conduct was willful within the meaning of Section 105(c)(7)(A) of the Act and Rule 5301(a).[17]

[17] Even if scienter were required to establish willfulness, for reasons set forth below in the discussion of sanctions, that requirement would be satisfied in this case.

I conclude, therefore, that Cordovano, after being barred from being associated with a registered public accounting firm by the 2008 Order, willfully remained or became an associated person of the Firm, in violation of Section 105(c)(7)(A) of the Act and Rule 5301(a), and that the Firm, with knowledge of the bar, permitted the association, in violation of Section 105(c)(7)(A) of the Act and Rule 5301(b). Furthermore, Cordovano, by willfully remaining or becoming an associated person of the Firm, in contravention of the bar set forth in the 2008 Order, and the Firm, by allowing Cordovano to do so, also violated Rule 5000, which requires registered public accounting firms and their associated persons to "comply with all Board orders to which the firm or person is subject."

B. Substantial Compliance Defense

In their pre-hearing submission, Respondents asserted for the first time in this proceeding that they cannot be held to have violated Section 105(c)(7)(A) of the Act and Rules 5000, 5301(a) and 5301(b), as charged, because they "substantially complied" with the bar imposed by the 2008 Order. Respondents reiterated this substantial compliance defense in their post-hearing submission. RPS at 25-27.

As Respondents note, in contempt of court cases, some courts have held that "a finding of contempt [may] be averted where diligent efforts result in substantial compliance with the underlying order." Accusoft Corp. v. Palo, 237 F.3d 31, 47 (1st Cir. 2001). The Division, however, argues that this substantial compliance defense is inapplicable to PCAOB proceedings, and that, even if the defense were applicable, Respondents failed to demonstrate that they made diligent efforts that resulted in substantial compliance with the bar.

I agree with the Division on both points. First, Respondents' contention that this proceeding is analogous to a contempt proceeding is incorrect. This is a disciplinary proceeding specifically authorized by Section 105(c)(7)(A) of the Act, not a contempt proceeding. The PCAOB's disciplinary proceedings are modeled on the disciplinary proceedings of the securities industry self-regulatory organizations (SROs), and as the SEC recently noted in a PCAOB case, "we have rejected similar attempts to apply civil contempt principles to violations of the rules of SROs." Gately, 2010 SEC LEXIS 2535, at *29.

Second, the evidence is fundamentally inconsistent with a finding that Respondents made "diligent efforts" to comply with the bar. On the contrary, after the 2008 Order was issued, Respondents established no written policies and procedures to assist the partners or the Firm staff in complying with the bar. Instead, Respondents' primary response to the bar was to make Zhou a non-equity partner and assign her as the engagement partner for a number of Firm audits of issuers. Because Zhou had no prior experience as an auditor of an issuer, in any role, Respondents knew that she would require a good deal of support from a more experienced auditor in order to fulfill her responsibilities, and they assigned Cordovano, who was barred, to provide that support. Tr. 982. This does not constitute taking "all reasonable steps to insure compliance." RPS at 25.

Respondents argue that their response to the bar was reasonable because neither the 2008 Order nor the Division's subsequent letter "provided anything in the way of clear instructions as to 'precisely what acts are forbidden.'" RPS at 25-26, quoting Accusoft Corp. v. Palo, 237 F.3d at 47. As explained above, however, the 2008 Order, the Act, the PCAOB's rules, and the Division's letter all clearly notified Respondents that Cordovano could not participate in any activity of the Firm in connection with the preparation or issuance of any audit report for an issuer. Further, Cordovano's and Honeck's testimony demonstrated that they both understood the scope of the bar. Finally, given the myriad ways in which an accountant can participate in audit activities, as demonstrated by Cordovano's activities, the Board and the Division could not have provided, and Respondents were not entitled to, a more detailed description of the prohibited acts.

The evidence also shows that Respondents' inadequate efforts did not lead to substantial compliance with the bar. As set forth above, Cordovano engaged in activities in connection with four separate audits that were proscribed by the bar. The number and range of those activities preclude any finding of substantial compliance.[18]

Therefore, I conclude that Respondents' substantial compliance defense is both legally and factually unsupported, and it is rejected.

C. Sanctions

The first issue in determining the appropriate sanctions for Respondents' violations is whether they resulted from "intentional or knowing conduct, including reckless conduct," or from "repeated instances of negligent conduct, each resulting in a violation" of relevant standards, within the meaning of Section 105(c)(5) of the Act. If either type of conduct occurred, the full range of potential sanctions set forth in Section

[18] I reach this conclusion without regard to Cordovano's post-audit activities. Even assuming those activities did not come within the definition of associated person, or if Cordovano reasonably believed they did not, his activities during the course of the four audits preclude any finding that Respondents substantially complied with the bar.

105(c)(4) of the Act and PCAOB Rule 5300 is available; if not, the potential sanctions are far more limited.

The SEC has held that "the knowledge, recklessness, and negligence standards in Section 105(c)(5) ... are similar to the standards for Commission discipline of accountants under Rule 102(e) of our Rules of Practice …." Gately, 2010 SEC LEXIS 2535, at *32. The SEC further explained: "Recklessness in this context, as under Rule 102(e), is an 'extreme departure from the standards of ordinary care, . . . which presents a danger' to investors or the markets 'that is either known to the (actor) or is so obvious that the actor must have been aware of it.'" Id. at *33 (footnote omitted). There is thus a two-prong test for evaluating whether Respondents' conduct was reckless: (1) whether their conduct represented an "extreme departure" from applicable standards; and (2) whether they "knew or must have known" that their conduct presented a danger to investors or the market. Id. at **34, 39.

Respondents argue that the evidence does not support a finding of recklessness because: (1) they sought assistance from the Division regarding their obligations under the bar and received no detailed description of the conduct that was covered by the bar; (2) they adopted a reasonable interpretation of the bar's prohibitions; (3) they made a reasonable response to the bar, as they understood it; and (4) Cordovano did not intend to violate the bar.

First, neither the Board nor the Division had a duty to provide Respondents with a roadmap to compliance. The SEC has "long held that regulated persons cannot avoid responsibility for their own violative conduct by blaming the Commission or other regulators." Gately, 2010 SEC LEXIS 2535, at *53. Furthermore, as explained above, the definition of associated person is broad, and encompasses a wide range of audit-related activities, and as a result, neither the Board nor the Division could have provided, in advance, a more detailed description of the conduct prohibited by the bar.

Second, as explained above, I reject Respondents' purported interpretation of the bar as neither reasonable nor credible. In fact, the testimony of both Cordovano and Honeck shows that they understood that the bar imposed a broad prohibition on Cordovano's involvement in audits of issuers.

Third, again as explained above, Respondents did not take reasonable steps to comply with the bar. In that regard, it is particularly troubling that Respondents seek to blame Zhou for their violations, asserting that "[i]n hindsight, Zhou was not qualified [to be the engagement partner on the Firm's audits]," and that, "[f]acing exigent client needs and an employee who was failing, Cordovano answered Zhou's requests for guidance and training. He answered Zhou because it was necessary to protect her, the [F]irm, and the interests of its clients and their shareholders." RPS at 1-2.

The exigencies that Respondents identify were caused, not by Zhou, but by Respondents' own decisions. Although Respondents accuse Zhou of "puffing her ability" (RPS at 1 n.1), in fact, Cordovano and Honeck were well aware that Zhou had no experience auditing issuers when the Firm hired her and when it assigned her to be the engagement partner on several audits. Respondents assert that Zhou "represented herself to be qualified" and that she "believed that she was qualified to be an engagement partner for public issuer clients." RPS at 1, 10. I find credible, however, Zhou's testimony that she understood she was hired for an audit manager position, and that she had "confidence in [herself] to work as [an] accounting manager." Tr. 30. I further credit her testimony that when Cordovano approached her about becoming a non-equity audit partner in January 2009, she did not "feel that confident to work as [an] engagement partner, but Mr. Cordovano told [her] he [could] walk [her] through." Tr. 36.

In any event, unlike Zhou, both Cordovano and Honeck were experienced auditors of issuers, and therefore must have been aware that Zhou could not possibly complete her assignments successfully without substantial oversight and input from at least one of the partners. Yet Cordovano, with Honeck's knowledge and implied consent, assigned that role to himself, even though he was barred from participating in the issuer audits to which Zhou was assigned. Both Cordovano and Honeck must have known that this arrangement was inconsistent with the requirements of the bar. And while Cordovano may not have specifically intended to violate the bar, the evidence shows that he deliberately remained deeply involved in the Firm's issuer audits in spite of the bar. Such involvement was implicit in the decision to make Zhou the non-equity engagement partner for numerous issuer audits, even though she was plainly not qualified to act in that role, and explicit in Cordovano's subsequent oversight of and participation in the audits, as discussed above.

I conclude that, rather than making reasonable efforts to comply with the bar, Respondents' conduct in allowing Cordovano to participate in Firm activities in connection with the preparation and issuance of audit reports represented an extreme departure from applicable standards. Cordovano and Honeck were both aware that Cordovano was prohibited from participating in any activity of the Firm in connection with its audits of issuers. Cordovano, however, while formally withdrawing from the Firm's audits, monitored their progress and intervened behind the scenes in order to influence auditing and accounting decisions. Cordovano must have known that his actions were impermissible in light of the bar.

Respondents contend that Cordovano was merely responding to Zhou's questions and acting as an intermediary between Zhou and Quijote-Oakes, "a role necessitated by their mutual antipathy." RPS at 15. The facts as set forth above demonstrate that Cordovano was far more involved than simply responding to questions or acting as an intermediary. Further, Cordovano must have realized, as Honeck did, that the bar prohibited him from "instructing the staff if it was related to performing a public company audit," regardless of his reasons for intervening.[19]

Finally, I note that Cordovano had been barred by the 2008 Order based on a finding, to which Respondents consented, that he had engaged in intentional or knowing misconduct, including reckless conduct, or repeated instances of negligent misconduct. Accordingly, I conclude that Respondents knew or must have known that allowing Cordovano to participate in the audits of issuers in the manner and to the extent that he participated in the audits of China Solar, Playlogic, ICOP, and Tombstone presented a danger to investors or the market.

Therefore, I conclude that Cordovano's conduct constituted "intentional or knowing conduct, including reckless conduct," within the meaning of Section 105(c)(5)

[19] Indeed, some of Cordovano's actions support an inference that he was aware that he was violating the bar. These actions include signing Honeck's name to an email to China Solar's management, and composing emails to Playlogic's management that he directed Zhou to send in her name. I reject as not credible Cordovano's testimony that he composed the Playlogic emails to assist Zhou, because of her limited English skills. The email communications themselves do not support Cordovano's claim; rather, they simply reflect Cordovano directing Zhou to send the client messages he had composed, and I credit Zhou's testimony that Cordovano asked her to send the messages because "he [could not] do the work until [the] fall of 2009" because of the bar. D-46; D-49; Tr. 58-61, 620-21. Because the Playlogic emails did not directly relate to the conduct charged in the OIP, however, I have not considered them in concluding that Cordovano engaged in intentional or knowing conduct, including reckless conduct.

of the Act. The Firm also engaged in "intentional or knowing conduct, including reckless conduct," within the meaning of Section 105(c)(5) of the Act. Cordovano's scienter can be imputed to the Firm, since he was part-owner. In addition, Honeck, the other co-owner, was generally aware of Cordovano's activities and took no steps to prevent Cordovano from participating in the Firms' audits. At a minimum, the Firm engaged in "repeated instances of negligent conduct, each resulting in a violation" of the Act and PCAOB rules.

Accordingly, I find that the full range of sanctions under Section 105(c)(4) of the Act is available to address Respondents' violations. The SEC has identified certain "public interest factors" as relevant in determining what specific sanctions are appropriate, including "the egregiousness of the respondent's actions; the isolated or recurrent nature of the infraction; the degree of scienter involved; the sincerity of the respondent's assurances against future violations; the respondent's recognition of the wrongful nature of his conduct; and the likelihood of future violations. [The] inquiry into the appropriate remedial sanction is a flexible one, and no one factor is dispositive." Chris G. Gunderson, Exch. Act Rel. No. 61234, 2009 SEC LEXIS 4322, at *20 (Dec. 23, 2009) (footnotes and internal quotation marks omitted).

In this case, Respondents' conduct was highly egregious. Following the bar, the Firm adopted no written guidelines to ensure that Cordovano would not participate in audits of issuers. Instead, Respondents' primary action was to remove Cordovano from overt participation in the Firm's audits of issuers by appointing Zhou as the non-equity engagement partner, while allowing Cordovano to remain involved in the audits behind the scenes. As explained above, Respondents' conduct was intentional or reckless, or at a minimum involved repeated negligent violations. Further, Respondents have not shown any recognition of the wrongful nature of their misconduct; instead, they have offered a variety of rationalizations.

All of these factors support imposing a permanent bar on Cordovano. Respondents, however, argue that such a bar is unnecessary because Cordovano is already subject to the bar in the 2008 Order. Respondents acknowledge that the 2008 Order allows Cordovano to petition the Board for consent to associate with a registered public accounting firm, but they argue that "Cordovano has no intention of petitioning for such approval, which would be an exercise in futility." RPS at 28. Cordovano's current intent, however, would not preclude him from petitioning for consent to associate at some future date. In any event, a permanent bar is an appropriate remedial sanction because it signals to Cordovano and others, who may be in similar situations, the importance of complying with Section 105(c)(7)(A) of the Act and Rules 5000 and 5301(a).

I also find it appropriate to revoke the Firm's registration. Respondents argue that "[t]he primary impact of [a revocation] would primarily fall on Honeck, who was conclusively shown at the hearing to have done nothing wrong." RPS at 28. In fact, Honeck's own testimony showed that he took no steps to ensure that Cordovano and the Firm complied with the bar, and closed his eyes in the face of evidence that Cordovano was engaging in activities in connection with audits of issuers that Honeck recognized violated the bar. The revocation of the Firm's registration, which is fully justified under the public interest factors identified by the SEC, thus works no unfairness on Honeck.[20]

[20] A civil money penalty is also a potential sanction under Section 105(c)(4) of the Act; the other types of sanctions authorized by that provision or by Rule 5300 have little utility in light of the permanent bar of Cordovano and revocation of the Firm's registration. In evaluating whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has considered the factors set forth in

IV. Record Certification

Pursuant to Rule 5202(d), I certify that the record includes the items set forth in the Revised Record Index sent to the parties by the PCAOB Secretary on June 24, 2011.

V. Order

In accordance with the findings and conclusions set forth above, pursuant to Section 105 of the Sarbanes-Oxley Act of 2002 and PCAOB Rule 5300, Respondent Samuel D. Cordovano is permanently barred from associating with any registered public accounting firm and Respondent Cordovano and Honeck LLP's registration with the Board is permanently revoked.

This Initial Decision shall become final, in accordance with Rule 5204(d)(1), upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision in accordance with Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.[21]

David M. FitzGerald
Hearing Officer

Section 21B(c) of the Securities Exchange Act of 1934 as providing helpful and relevant guidance. Larry O'Donnell, CPA, P.C. and Larry O'Donnell, CPA, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10.

In this case, those factors might well support the imposition of a substantial civil money penalty, at least as to Cordovano. The Division, however, did not request the imposition of a civil money penalty and Respondents did not address the penalty issue in their post-hearing filing, presumably because the Division did not seek a penalty. Although those factors do not preclude a penalty, to impose a penalty without offering Respondents a clear opportunity to address the relevant factors might raise fairness concerns. Furthermore, I do not find a penalty essential to accomplish the PCAOB's remedial and disciplinary goals under the facts of this case. Accordingly, no civil money penalty will be imposed.

[21] Arguments and contentions of the parties not specifically addressed herein are adopted or rejected to the extent that they are consistent or inconsistent with the findings and conclusions set forth.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of R.E. Bassie & Co. and R. Everett Bassie, CPA	PCAOB File No. 105-2009-001
	FINAL DECISION
Respondents.	October 6, 2010

Appearances

Robert A. Berger, Esq., Washington, DC, for the Division of Enforcement and Investigations.

Dwight E. Jefferson, Esq., Houston, TX, for Respondents.

Petition for review filed: April 20, 2009
Last brief received: June 19, 2009

I.

R.E. Bassie & Co. ("REB"), a registered public accounting firm, and R. Everett Bassie ("Bassie") (collectively, "Respondents") appeal from a Hearing Officer's decision revoking REB's registration with the Public Company Accounting Oversight Board and permanently barring Bassie from association with any registered public accounting firm. The Hearing Officer ordered the sanctions after finding, in ruling on a motion for summary disposition, that Respondents failed to cooperate with a Board investigation. Our decision is based on a *de novo* review of the record, except as to those findings not challenged on appeal. We find that Respondents engaged in conduct constituting noncooperation with an investigation. Because of that conduct, we permanently revoke REB's registration, we permanently bar Bassie from being an associated person of a registered public accounting firm, and we impose a civil money penalty of $75,000 on Bassie.

II.

REB is a public accounting firm located in Houston, Texas and organized as a sole proprietorship under Texas law. It has been registered with the PCAOB pursuant to Section 102 of the Sarbanes-Oxley Act of 2002 (the "Act") and PCAOB Rules since October 2003. Bassie is a certified public accountant licensed in Texas. At all relevant times, Bassie was the sole proprietor of REB, and an associated person of a registered public accounting firm as defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i).

On January 10, 2006, the Board issued an order of formal investigation ("OFI") pursuant to PCAOB Rule 5101(a)(1). The OFI stated that the Board had received information indicating that REB and one or more of its associated persons may have violated PCAOB Rules 3100 and 3200T by failing to comply with certain PCAOB standards in auditing and reviewing the financial statements of a company specified in the OFI ("Issuer A"). The OFI authorized an investigation to determine whether REB or any associated person of REB had engaged in the specified acts or practices or in "acts or practices of similar purport or object." The OFI authorized the Division of Enforcement and Investigations ("the Division") to issue Accounting Board Demands ("ABDs") for documents and testimony that was "relevant to the matters described in this Order of Formal Investigation."

A. The ABDs Related to Issuer B

In the period shortly following issuance of the OFI, the Division issued at least two ABDs to Respondents requiring the production of documents concerning Issuer A.[1/] On at least three days in March and May 2006, Bassie provided testimony in the investigation. Excerpts of Bassie's testimony contained in the record include descriptions of relationships between Bassie, Issuer A, individuals associated with Issuer A, and other entities and individuals.

On November 17, 2006, the Division sent an ABD requiring REB to produce documents relating to an issuer whose financial statements REB had audited and one of that issuer's subsidiaries (collectively, "Issuer B"), neither of which is identified in the OFI. On February 16, 2007, the Division sent an ABD to Bassie, requiring production of essentially the same documents as described in the November 17 ABD to REB.

[1/] The Division has not alleged noncooperation by Respondents with respect to those ABDs.

Respondents never produced any documents in response to those two ABDs (collectively, the "Issuer B ABDs").

From December 2006 to June 2007, the Division made repeated efforts to obtain compliance with the Issuer B ABDs and regularly reminded Respondents of the possibility of sanctions for noncooperation if they failed to produce the documents. In that period, Respondents retained new counsel who, in a letter to the Division dated January 12, 2007, requested the November 17 ABD and represented that previous counsel had failed to provide it to Respondents. After receiving the ABD, Respondents' new counsel sent the Division a letter dated January 23, 2007, stating, among other things, that his client "is cooperating with your request and is in the process of locating said information" (emphasis in original), but also noting that because Respondents had very limited staff and were in the middle of tax season, it was "going to take some time to locate all of the information that you are requesting." The letter also raised a question about the fact that the OFI mentioned in the Division's letter with the ABD identified only Issuer A, and that the information being requested was for Issuer B. The letter requested copies of the Board's formal orders concerning Issuer A and Issuer B.

The Division responded in a letter dated February 2, 2007, which stated that it was confirming a January 30 telephone discussion with Respondents' counsel. In response to counsel's point about the OFI, the Division stated that "the OFI expressly provides that the Division may investigate not only matters involving the audits and reviews of [Issuer A], but also may investigate any acts or practices of similar purport or object.'"

By letter dated March 3, 2007, Respondents' counsel told the Division that he had reviewed provisions of law to which the Division had directed him concerning the authority to require production of documents related to Issuer B, and that he had "not found a section in the code that provides you the authority to request the information concerning the companies listed above, under an order of investigation for an entirely unrelated company and order." The March 3 letter also stated, however, that it was "requiring a considerable amount of time to collect [the documents] and then to prepare them for inspection according to your request," and that it was unreasonable to "require Mr. Bassie to halt his practice in the middle of tax season" in order to gather the documents "at the pace that you are requesting." The letter reiterated that "[w]hat we have and continue to ask for is additional time until the end of the tax season to complete your request."

Letters from the Division to Respondents' counsel dated March 27, May 17, and June 1 of 2007 all repeated the demand for production. After the March 3 letter discussed above, however, there is no record evidence of any communication from Respondents concerning the Issuer B ABDs.

By letter dated September 10, 2007, the Division informed Respondents that it intended to recommend that the Board institute a disciplinary proceeding to consider whether to impose sanctions on Respondents for, among other things, failing to comply with the Issuer B ABDs. Pursuant to PCAOB Rule 5109(d), the letter allowed Respondents an opportunity to submit a written statement of position on whether a disciplinary proceeding should be instituted and gave them until September 25, 2007 to do so. Through counsel, Respondents requested, and the Division granted, an extension of that deadline to October 2, 2007. Respondents then changed counsel again, and new counsel requested and obtained further extensions of the deadline, first to November 1, and finally to December 3, 2007. Despite requesting and receiving those extensions, Respondents neither submitted a statement of position nor produced documents responsive to the Issuer B ABDs.

B. Procedural History

The Board issued an Order Instituting Disciplinary Proceedings ("OIP") against Respondents on January 9, 2009. The OIP alleged, among other things, that Respondents engaged in conduct constituting noncooperation with an investigation by failing to comply with the Issuer B ABDs. Respondents filed a timely answer in which they denied the allegations that they had failed to cooperate with the investigation.

On April 8, 2009, the Hearing Officer issued an initial decision granting the Division's motion for summary disposition on the noncooperation allegations. The Hearing Officer found that each Respondent had failed to cooperate with the investigation by failing to comply with the Issuer B ABD directed to that Respondent. The Hearing Officer concluded that those failures warranted revocation of REB's registration and a bar on Bassie's association with a registered public accounting firm, and the Hearing Officer ordered those sanctions.

Respondents filed a timely petition for Board review of the initial decision on April 20, 2009. On May 5, 2009, Respondents filed an amended petition for review to which they attached an affidavit of Bassie. On June 5, 2009, the Division filed a motion to strike Bassie's affidavit. The parties also filed briefs on the merits of the case, with briefing completed on June 19, 2009, pursuant to the Board's briefing schedule.

III.

A. Summary Disposition Standard

Rule 5427(d) provides that "[t]he hearing officer shall promptly grant a motion for summary disposition if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a disposition as a matter of law." This rule, in substance, parallels Rule 56 of the Federal Rules of Civil Procedure, as well as Rule 250 of the SEC Rules of Practice. Under these provisions, the ultimate question is whether the record as a whole demonstrates the existence of any factual disputes that must be resolved through a hearing. "[A] party seeking summary judgment [must] make a preliminary showing that no genuine issue of material fact exists. Once the movant has made this showing, the nonmovant must contradict the showing by pointing to specific facts demonstrating that there is, indeed, a trialworthy issue." National Amusements, Inc. v. Town of Dedham, 43 F.3d 731, 735 (1st Cir. 1995).

To preclude summary disposition, any unresolved factual issues must be both genuine and material – "the mere existence of some alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no genuine issue of material fact." Anderson v. Liberty Lobby, Inc., 477 U.S. 242-247-48 (1986) (emphasis in original). In considering a motion for summary disposition, the record will be viewed most favorably to the non-moving party, but "we need not credit purely conclusory allegations, indulge in rank speculation, or draw improbable inferences." National Amusements, 43 F.3d at 735. "Where the record taken as a whole could not lead a rational trier of fact to find for the nonmoving party, there is no 'genuine issue for trial.'" Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986) (quoting Fed. R. Civ. P. 56(e)).

B. Noncooperation with the Investigation

It is undisputed that in the period between the first Issuer B ABD on November 17, 2006, and the institution of disciplinary proceedings on January 9, 2009, Respondents produced no documents responsive to the Issuer B ABDs. It is also undisputed that, during that period, Respondents possessed documents responsive to those ABDs.[2/] In addition, Respondents do not dispute in their briefs before us, and did

[2/] This point is acknowledged by Respondents' counsel in various places, including in letters to the Division dated January 23, 2007 (noting that "my client is in the process of obtaining your requested information") (emphasis in original) and March 3, not dispute in the proceedings before the Hearing Officer, that the Issuer B ABDs are within the scope of the ABDs authorized by the OFI.

Respondents argue, however, that summary disposition was inappropriate because a genuine issue of material fact exists concerning whether they relied on legal advice to the effect that they were not obligated to produce documents concerning companies not specified in the OFI.[3/] Before the Hearing Officer, Respondents raised this point only by saying, in their opposition to the Division's motion for summary disposition, that they "submit as their defense . . . their reliance on advice of counsel in failing to produce documents . . . ." Respondents proffered no evidence of such advice and, instead, tried to suggest that the record already contained evidence of it:

> [B]y letter dated January 23, 2007, Respondent's counsel noted to Enforcement that the documents requested by the ABD related not to [Issuer A], the company that was the source of Respondents' work and the object of the OFI, but rather the requested documents identified [Issuer B], an unrelated entity. . . . It was evident to Enforcement that by Respondents' failure to respond to Enforcement's letter of May 17, 2007, demanding compliance with the ABDs was because counsel for Plaintiff [*sic*] was in fact objecting to the requests for [Issuer B] documents in the [Issuer A] investigation.[4/]

In briefing before us, Respondents more directly assert that the passages concerning the OFI in counsel's January 23, 2007, and March 3, 2007, letters are evidence of the legal advice. Respondents argue that counsel's assertion in the March 3 letter that he found no authority for the Division to seek the Issuer B documents "is the

2007 (noting that "the documents that you are requesting are several years old and it is requiring a considerable amount of time to collect them and then to prepare them for inspection"), and in Respondents' brief before us on review (noting "the voluminous nature of the records" and suggesting that they could be made available now).

[3/] During the investigation, Respondents were represented by different counsel than the counsel who has represented them before the Hearing Officer and before us in this review.

[4/] Respondents' Response to the Division of Enforcement and Investigations' Motion for Summary Disposition (March 24, 2009), at 2.

advice on which Bassie reasonably relied"[5] and therefore is sufficient to show that there is a genuine issue of fact concerning whether Respondents received and reasonably relied on such advice.

We do not view the letters as sufficient for that purpose. Without a doubt, the letters reflect that counsel thought about the scope of authority provided by the OFI. In their totality, though, the letters cannot fairly be viewed as evidence that counsel had advised Respondents that they were not obligated to produce the documents and that Respondents were relying on that advice. Each letter stated that Respondents were cooperating with the request and were in the process of gathering the information, and each letter expressed a need for additional time, until after tax season, to complete the task. Indeed, Respondents' petition for Board review of the Initial Decision emphasized that the letters stood for those latter points and that the Division had "unreasonably interpreted Respondents' requests for additional extensions of time due to tax season as intentional non-cooperation with the investigation."[6]

Respondents have now attempted to supplement the record with an affidavit from Bassie that they did not provide to the Hearing Officer.[7] On the advice-of-counsel point, Bassie's affidavit states that "I reasonably relied in good faith on counsel's advice that Enforcement did not have the authority to demand documentation regarding [Issuer B] because [Issuer B] was not the subject of the Board's investigation," and provides no further detail.

Under PCAOB Rule 5464, a party may file a motion for leave to adduce additional evidence at any time before issuance of a decision by the Board. The rule requires the movant to "show with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously." No such motion accompanies Bassie's affidavit.

[5] Respondents' Opening Brief (May 29, 2009) at 6; see also Respondents' Reply Brief (June 19, 2009) at 1.

[6] Respondent's Petition for Review of the Initial Decision of the Hearing Officer (April 20, 2009), at 1.

[7] The affidavit is an exhibit to Respondents' First Amended Petition for Review of the Initial Decision of the Hearing Officer (May 5, 2009).

Without reaching the question of whether the additional evidence would make a difference to the outcome,[8/] we have determined not to allow the additional evidence on this point because Respondents have not filed a motion describing any grounds for their failure to adduce it in the proceedings before the Hearing Officer,[9/] and it is not apparent from anything in the record what possible grounds there could be.[10/] In reaching this determination, we have considered the ease with which Respondents could have presented the same evidence to the Hearing Officer, the ample notice Respondents had of the need to do so,[11/] and the importance to our process of having parties present all relevant evidence to the Hearing Officer in the first instance.

[8/] Even if we were to allow the additional evidence, there would be a significant question about whether Bassie's affidavit alone is sufficient to make out the existence of a genuine issue of fact that precludes summary disposition. At a hearing, Bassie would not be able to establish the fact of reliance on advice of counsel based on "nothing other than his say-so," but would need to introduce an opinion letter or other "evidence of actual advice from an actual lawyer." SEC v. McNamee, 481 F.3d 451, 456 (7th Cir. 2007). Accordingly, it is far from clear that Bassie's mere assertion, in the most conclusory and vague terms possible, would be sufficient to create a genuine issue of fact for purposes of precluding summary disposition. Moreover, even if we were to determine that a genuine issue of fact exists, we would need to consider whether reliance on legal advice is material to the question of whether Respondents' conduct constituted noncooperation and, even if not material to that question, whether it is material to the question of sanctions. Because we do not allow the additional evidence, we do not reach these questions.

[9/] Rule 5464 is substantively identical to Rule 452 of the Securities and Exchange Commission's Rules of Practice. Under Rule 452, the Commission has declined to allow additional evidence in circumstances where the evidence was not accompanied by a motion that described the grounds for failing to adduce the evidence earlier. See, e.g., Warwick Capital Management, Inc., Investment Advisers Act Rel. No. 2694 (Jan. 16, 2008), WL 149127 at *5 nn.12-13; Harold F. Harris, Exchange Act Rel. No. 53122A (Jan. 13, 2006), 2006 WL 307856, at *5, n.23.

[10/] On June 5, 2009, the Division filed a Motion to Strike Affidavit of R. Everett Bassie, noting that if Respondents had complied with Rule 5464 by filing a motion, the Division would have opposed the motion. In light of our ruling on the additional evidence, the Division's motion to strike is moot.

[11/] The Hearing Officer's February 6, 2009, Case Management Order stated that if a party opposes a summary disposition motion and contends that material facts

In addition, although not dispositive of the question, in considering the fairness of not allowing the late submission of Bassie's affidavit on this point, we have taken into account two related points. First, the affidavit is at odds with what Respondents repeatedly told the Division during the investigation – that they were gathering the documents, intended to cooperate, and just needed an extension until after tax season. Second, the affidavit is also at odds with what Respondents asserted in their petition for Board review of the Hearing Officer's decision – that "Respondents' request for an extension until after tax season was a reasonable request" and the Division had "unreasonably interpreted Respondents' requests for additional extensions of time due to tax season as intentional non-cooperation with the investigation."[12/]

Section 105(b)(3) of the Act, captioned "Noncooperation with Investigations," authorizes the Board to impose sanctions if a registered firm or associated person "refuses to testify, produce documents, or otherwise cooperate with the Board in connection with an investigation" and PCAOB Rule 5300(b) similarly provides for sanctions if such a firm or person "has failed to comply with an accounting board demand, has given false testimony or has otherwise failed to cooperate in an investigation." There is no genuine issue of material fact concerning whether Respondents failed to produce documents in response to the Issuer B ABDs. Nor is there evidence in the record sufficient to indicate a genuine issue of material fact bearing on an asserted defense based on reliance on legal advice.

Although section 105(b)(3) of the Act authorizes the Board to impose sanctions for noncooperation with an investigation if a registered firm or associated person "refuses" to testify, produce documents, or otherwise cooperate, we do not understand that provision to limit our sanctioning authority to cases involving an express refusal. To hold otherwise would render section 105(b)(3) a dead letter, since any noncooperating registered firm or associated person could then avoid section 105(b)(3) sanctions merely by refraining from expressly articulating a refusal to cooperate.

In this case, Respondents received repeated demands to comply with the Issuer B ABDs, including demands that described the risk of sanctions for failing to comply.

are in genuine dispute, "the party shall cite and submit supporting evidence in the same manner as required of the moving party."

[12/] Respondents' petition for Board review separately includes, as its fourth and final point, reference to Bassie's purported reliance on advice of counsel in not producing the documents, but it makes no attempt to reconcile that point with the petition's first point, described in the text above.

Respondents' failure to produce the demanded documents continued for approximately 10 months between the initial production deadline and the Division's letter advising Respondents that the Division intended to recommend disciplinary proceedings, and continued thereafter, up to and following the institution of disciplinary proceedings. After initial attempts to postpone production deadlines, Respondents simply stopped responding to the Division's continuing demands for compliance. On these facts, even in the absence of an express refusal to cooperate, we conclude that summary disposition was appropriate and that each Respondent's conduct constitutes noncooperation for which we may impose sanctions.

IV.

For noncooperation with an investigation, the Board is authorized to revoke or suspend a firm's registration, to bar or suspend an individual from association with any registered public accounting firm, or to impose certain lesser sanctions as the Board considers appropriate and as specified by rule of the Board.[13/] The Hearing Officer found that the appropriate sanctions for Respondents' failures to produce documents in response to the Issuer B ABDs are revocation of REB's registration and a bar against Bassie being associated with any registered public accounting firm. We agree that those sanctions are appropriate. We also conclude that it is appropriate to impose a civil money penalty against Bassie.

A. Revocation and Bar

Respondents argue that the sanctions imposed by the Hearing Officer, revocation and bar, are too severe, "most importantly" because there is no evidence that Issuer A's investors or any other investors have been harmed by the failure to produce the documents.[14/] This argument misapprehends the threat to the system of Board oversight posed by noncooperation with an investigation.

The Board's power to investigate possible violations and to impose appropriate sanctions[15/] is fundamental to its ability to "protect the interests of investors and further

[13/] See Section 105(b)(3) of the Act and PCAOB Rule 5300(b). Rule 5300(b) specifies, by incorporating certain provisions of Rule 5300(a), that those lesser sanctions may include civil money penalties.

[14/] Respondents' Opening Brief at 8; Respondents' Reply Brief at 6-7.

[15/] See Sections 101(c)(4), 105(b)(1), and 105(c)(4) of the Act.

the public interest in the preparation of informative, accurate, and independent audit reports."[16/] Conducting investigations in an appropriate and timely manner depends upon registered firms' and associated persons' compliance with demands for documents and testimony made pursuant to the Board's authority under the Act. Noncooperation frustrates the oversight system by impeding the Board's ability to determine whether violations have occurred for which sanctions should be imposed, including sanctions that would protect investors from further violations, and thus deprives investors of an important protection that the Act was intended to provide. The question whether any specific harm to a particular investor can be tied directly to Respondents having thwarted such an investigation is not relevant to consideration of the sanction for their having done so.[17/]

Respondents contend that the sanctions analysis should take account of their new offer to make the documents available for review and copying by the Division. Respondents made the offer in their May 29, 2009 opening brief before the Board,[18/] and do not appear from the record to have made it at any earlier point – not in response to the Division's repeated communications between December 2006 and June 2007, not in response to the Division's September 2007 letter warning Respondents that the Division intended to recommend disciplinary proceedings, not in response to the institution of disciplinary proceedings, and not in response to the Division's motion for summary disposition before the Hearing Officer. It was only after the Hearing Officer granted summary disposition that Respondents made this offer, on the basis of which they now argue that "only the delay in the production of the documents should be considered in assessing any sanctions."[19/] We do not agree with Respondents' characterization of their failure as a "delay," nor do we view their offer to make

[16/] Section 101(a) of the Act.

[17/] Cf. In the Matter of the Application of Gately & Associates, LLC and James P. Gately, CPA for Review of Disciplinary Action by PCAOB, SEC Release No. 34-62656 (August 5, 2010) at 22-23 (absence of fraud or deceit does not diminish seriousness of failure to cooperate in PCAOB inspection designed, among other things, to uncover such misconduct).

[18/] See Respondents' Opening Brief at 6-7.

[19/] Respondents' Reply Brief at 4.

documents available now as a factor to be given any weight in the sanction determination.[20/]

Respondents also argue that the sanctions imposed by the Hearing Officer are "harsh and excessive" in light of the fact that Respondents relied on advice of counsel in not producing the documents. For the reasons described above, the record does not support the conclusion that Respondents received and relied on the purported advice of counsel, and Respondents did not make a submission sufficient to establish, on that point, that there is a genuine issue of fact that would require a hearing to resolve. Accordingly, Respondents' purported reliance on advice of counsel is not a factor in the sanctions analysis.

We find that Respondents' conduct warrants revocation of REB's registration and a bar on Bassie's association with any registered public accounting firm. In a Board investigation, Respondents received document production demands in response to which they produced none of the demanded documents. They continued not to produce the demanded documents despite the Division's repeated warnings, over several months, that such noncooperation could result in disciplinary sanctions. In response to the Division's communications and warnings, Respondents for a while told the Division that they intended to cooperate and just needed more time, but Respondents later simply stopped responding concerning the demand.

This type of noncooperation undermines the Board's ability to protect investors and advance the public interest by identifying and addressing misconduct in connection with the audits of public companies' financial statements. In the absence of any mitigating circumstances, such noncooperation indicates a lack of sufficient regard for Board processes and authority designed by statute to protect investors. If REB were to remain a registered firm and Bassie an associated person, they would have opportunities to similarly undermine those processes, and the related investor protection, in the future.

[20/] Cf. Gately, SEC Release No. 34-62656 at 23 (applying, in the context of PCAOB inspection demands, principle that "disciplinary proceedings should not be required in order to compel compliance"); CMG Institutional Trading, Exchange Act Rel. No. 59325, 2009 SEC LEXIS 215, at *20 (Jan. 30, 2009) ("we have emphasized repeatedly that NASD should not have to initiate disciplinary action to elicit a response to its information requests made pursuant to Rule 8210").

B. Civil Money Penalty

Although not included in the Hearing Officer's initial decision, we also find that Respondents' conduct warrants the imposition of a civil money penalty. Section 105(c)(4) of the Act authorizes the Board to impose such "disciplinary or remedial sanctions as it determines appropriate" for violations of certain laws, rules, and standards, and specifies that those sanctions may include civil money penalties up to specified maximum amounts. Although that provision is separate from section 105(b)(3)'s provision authorizing sanctions for noncooperation with an investigation, section 105(b)(3) authorizes the Board to impose "such other lesser sanctions" (in addition to bars, revocations, and suspensions) as the Board specifies by rule, and the Board's rules implementing that authority incorporate, as such lesser sanctions, the civil money penalty provisions found in section 105(c)(4).[21/]

In considering whether a civil money penalty is an appropriate disciplinary or remedial sanction, we are guided by the statutorily prescribed objectives of any exercise of our sanctioning authority: the protection of investors and the public interest. See section 101(a) of the Act (Board established "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports"); section 101(c)(5) (Board to perform duties or functions as the Board determines necessary "to carry out this Act, in order to protect investors, or to further the public interest"). We are also cognizant that the Securities and Exchange Commission ("Commission"), in reviewing any contested sanctions that we impose, is called upon to do so with "due regard for the public interest and the protection of investors."[22/]

In considering the exercise of our authority to impose civil money penalties, we have taken into account the factors enumerated in, and the Commission's application of, a somewhat comparable statutory authorization in the Securities Exchange Act of 1934 ("Exchange Act"). Like the authorization to the Board in the Act, section 21B of the Exchange Act authorizes the Commission to impose civil money penalties in administrative proceedings, up to specified maximum amounts, if the Commission finds that "such penalty is in the public interest."[23/] Unlike the Act, however, Exchange Act

[21/] See PCAOB Rule 5300(b)(1) (incorporating sanctions described in Rule 5300(a)(4)).

[22/] Section 107(c)(3) of the Act.

[23/] Section 21B(a) of the Exchange Act.

section 21B provides guidance regarding relevant factors "[i]n considering under this section whether a penalty is in the public interest."[24/] The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.

Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered. See In the Matter of Next Financial Group, Inc. 93 SEC Docket 1369, 2008 WL 2444775 at *49 (June 18, 2008) (Initial Decision) ("Not all factors may be relevant in a given case, and the factors need not all carry equal weight"). The Commission has imposed civil money penalties under section 21B on numerous occasions, emphasizing various of these factors, including in cases in which the Commission imposed a bar in addition to the civil money penalty. See, e.g., In the Matter of VFinance Investments Inc. and Richard Campanella, SEC Release No. 34-62448, 2010 WL 2674858 at * 18 (July 2, 2010) (barring individual from association with any broker or dealer in principal or supervisory capacity and imposing $30,000 civil money penalty described as "warranted to create a monetary incentive for Respondents and other industry participants to fulfill their recordkeeping obligations and cooperate with regulatory inquiries – particularly when, as in this case, such person is aware that compliance may reveal regulatory violations potentially resulting in disgorgement or monetary penalties"); In the Matter of Gregory O. Trautman, SEC Release No. 34-61167, 2009 WL 4828994 at *22-23 (December 15, 2009) (barring individual from association with any broker or dealer and imposing a $120,000 civil money penalty as "necessary to deter others" from such conduct, and in light of fact that conduct involved deception causing harm to others and resulting in enrichment of individual's firm); In the Matter of Guy P. Riordan, SEC Release No. 34-61153, 2009 WL 4731397 at *21-22 (December 11, 2009) (barring individual from association with any broker or dealer and imposing separate $100,000 civil money penalties for each of five violations in light of fact that conduct involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement and resulted in substantial pecuniary gain); In the Matter of Joseph John VanCook, SEC

[24/] Section 21B(c) of the Exchange Act.

Release No. 34-61039, 2009 WL 4005083 at *18 (November 20, 2009) (barring individual from association with any broker or dealer and imposing $100,000 civil money penalty described as "an amount necessary to deter VanCook from future misconduct" and that "will also have a remedial effect of deterring others from engaging in the same misconduct").[25/]

The courts have recognized that Commission sanctions involving bars and section 21B civil money penalties are appropriate, and should be upheld absent a "gross abuse of discretion," given that "Congress has charged the Commission with protecting the investing public," and the question of appropriate remedies is "peculiarly a matter for administrative competence." Rizek v. SEC, 215 F.3d 157, 160 (1st Cir. 2000) (upholding bar on individual's association with any broker, dealer, member of a national securities exchange, or member of a registered securities association and imposition of $100,000 civil money penalty) (quoting A.J. White & Co. v. SEC, 556 F.2d 619, 624 (1st Cir. 1977), and Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 185 (1973)).

The Board, too, is charged to exercise its sanctioning authority "as the Board considers appropriate"[26/] (subject to Commission review) to protect the investing public. Looking to the Exchange Act section 21B factors and precedent for guidance on protecting investors and advancing the public interest through civil money penalties,[27/] we conclude that a civil money penalty is plainly appropriate in this case.

[25/] Trautman, Riordan, and VanCook all involved financial harm to investors that the Commission orders addressed through substantial disgorgement remedies (more than $600,000 in Trautman, more than $900,000 in Riordan, and more than $500,000 in VanCook), underscoring that the separate civil money penalty is imposed for a purpose distinct from making a financially harmed victim whole.

[26/] Section 105(b)(3)(A)(iii) of the Act; see also Section 105(c)(4) of the Act ("Board may impose such disciplinary or remedial sanctions as it determines appropriate").

[27/] Relevant, and similar, guidance is also provided by the courts even outside of the section 21B context. See McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005) (factors relevant in deciding whether a sanction is appropriately remedial include "the seriousness of the offense, the corresponding harm to the trading public, the potential gain to the [offender] for disobeying the rules, the potential for repetition in light of the current regulatory and enforcement regime, and the deterrent value to the [offender] and others").

In response to the Issuer B ABDs, Respondents disregarded their obligation to cooperate with the Board's investigation. On the record, as described above, it is clear that this disregard was deliberate or reckless. Respondents produced none of the demanded documents, continued not to produce them despite the Division's repeated warnings, over several months, that such noncooperation could result in disciplinary sanctions, and, after first telling the Division that they intended to cooperate and just needed more time, simply stopped responding concerning the demand.

We also conclude that Respondents' conduct caused at least indirect harm to others. Investors and markets are put at risk, and perhaps harmed in ways that never become known, when a regulatory investigation is improperly thwarted by a regulated person's refusal to provide information. Such noncooperation undermines the Board's ability to protect investors and advance the public interest by identifying and addressing misconduct in connection with the audits of public companies' financial statements. The undermining of this protection is a harm to investors and markets that factors into a sanctions analysis. Cf. Gately, SEC Release No. 34-62656 at 19 (recognizing as obvious the risk to investors and markets posed by a failure to produce information in a Board inspection).

We have also considered together the section 21B factors concerning whether any person was unjustly enriched and whether there is a need to deter such person and other persons from similar noncooperation. The obligation of registered firms and associated persons to cooperate with the Board is a fundamental aspect of PCAOB registration status. Yet, under the processes set out in the Act and the Board's rules, it necessarily takes some time before Board disciplinary sanctions in response to noncooperation are imposed and take effect. During that time, nothing prevents the firm or person from continuing to reap financial benefits from performing audit services for issuers, all the while ignoring the corresponding cooperation obligation that is essential to the Board's ability to protect investors in those issuers.

In short, in the absence of a civil money penalty, noncooperation with the Board might seem to certain kinds of individuals – who fear that cooperation will provide information that would lead to sanctions for violations of laws, rules, or standards – to be the course most likely to prolong the period of their registration and allow them to maximize their income from issuer audit work before being sanctioned. A civil money penalty for noncooperation is appropriate both as a deterrent to that kind of reasoning and conduct, see VFinance Investments, 2010 WL 2674858 at * 18 (civil money penalty warranted to create incentive for respondents and other industry participants to cooperate with regulatory inquiries, particularly when aware that compliance may reveal regulatory violations potentially resulting in disgorgement or monetary penalties), and, where applicable, to take account of the fact that financial gains from continuing to perform issuer audit work while not fulfilling the responsibilities that accompany PCAOB registration status might fairly be viewed as similar to unjust enrichment.[28/]

In our view, the factors described above weigh strongly in favor of imposing a civil money penalty in addition to the other sanctions in this case.[29/] We also consider, however, certain process points. The Division, in its motion for summary disposition, requested that the Hearing Officer impose civil money penalties in specified amounts.

[28/] We find nothing in the record of this case concerning whether Respondents received income from issuer audit work during the period of their noncooperation, and our sanction decision is not based on any understandings or assumptions on that point. We note, however, that in public filings with the Commission, issuers have disclosed paying audit fees to REB totaling $154,000 for audit services performed during the period of Respondents' noncooperation. See Form 10-K/A filed by FTS Group, Inc. on May 15, 2008 (including REB audit report dated April 11, 2008 on financial statements for period ended December 31, 2007 and disclosing audit fees of $45,000 to REB); Form 10-KSB filed by Larrea Biosciences Corporation on August 6, 2007 (including REB audit report dated July 26, 2007 on financial statements for period ended April 30, 2007 and disclosing audit fees of $64,000 to REB); Form 10-K/A filed by FTS Group, Inc. on April 16, 2007 (including REB audit report dated April 11, 2007 on financial statements for period ended December 31, 2006 and disclosing audit fees of $45,000 to REB).

[29/] We have also considered the section 21B factor concerning whether a person has previously been found by another appropriate regulatory agency or a self-regulatory organization to have violated relevant federal or state laws. In the context of a registered public accounting firm, we view findings of a state board of accountancy as a potentially relevant factor. Cf. section 2(a)(1) of the Act (defining "appropriate state regulatory authority" to include "the State agency or other authority responsible for the licensure or other regulation of the practice of accounting in the State or States having jurisdiction over a registered public accounting firm or associated person thereof"). The record indicates that the Texas State Board of Public Accountancy reprimanded Bassie in 2001 for failing to respond to communications from the Texas State Board in violation of state law and that agency's rules, and required Bassie to pay $250 in administrative penalties, pay $500 in administrative costs, and complete six hours of continuing professional education in the area of professional ethics. On the limited information about that matter in the record, however, we do not treat this factor as significant to our consideration of whether to impose a penalty.

Respondents' opposition to that motion focused on liability issues and did not address the penalty issue. As the Hearing Officer then issued his initial decision without imposing a civil money penalty,[30/] and as the Division has not renewed its request for a civil money penalty before us, Respondents did not have any subsequent occasion to argue specifically against a penalty. Somewhat related to that point, a respondent in the Exchange Act section 21B context may present, and the Commission, in determining whether a penalty is in the public interest, may in its discretion consider, evidence of the respondent's ability to pay.[31/] Respondents here have not had a specific opportunity to present evidence on their ability to pay a penalty.

We do not view either point as an obstacle to imposition of a penalty at this stage in the process. With regard to ability to pay, even if we were guided by the Exchange Act section 21B(d) approach, that approach commits to the agency's discretion the question of whether ability to pay is relevant to penalty considerations in any particular case.[32/] For various reasons, ability to pay might be irrelevant. See, e.g., Trautman, 2009 WL 4828994 at *23 (even accepting respondents' financial statements at face value, "egregiousness of Trautman's conduct outweighs any discretionary waiver, and penalty, among other sanctions, was "necessary to deter others"); VanCook, 2009 WL 4005083 at *19 ("conduct was sufficiently egregious to outweigh any consideration of [respondent's] inability to pay" and penalty, among other sanctions, was "necessary . . . to deter him and others" from such conduct). Because of the seriousness with which we view noncooperation, the egregiousness of Respondents' noncooperation, and the need to protect investors and advance the public interest by deterring such noncooperation, evidence concerning Respondents' ability to pay a penalty would be irrelevant to our determination of whether to impose a penalty.

Given the irrelevance of evidence bearing on ability to pay, and the nature of the arguments that Respondents have already made, we see no need to provide Respondents with a separate opportunity to argue specifically against the imposition of

[30/] The initial decision did not address the Division's request for civil money penalties.

[31/] See section 21B(d) of the Exchange Act.

[32/] See section 21B(d) of the Exchange Act; cf. Rule 630(a) of the Commission's Rules of Practice ("Commission may, in its discretion . . . consider evidence concerning ability to pay in determining whether . . . a penalty is in the public interest").

a civil money penalty. Respondents have had an opportunity to argue against the factual and legal conclusions (relating to their noncooperation) that provide the basis for the Board's authority to impose a civil money penalty. For the reasons described earlier, we have rejected their arguments, and those issues need not be reargued in the specific context of our consideration of sanctions beyond those imposed in the initial decision. The other factors described above, which we have identified as weighing strongly in favor of a civil money penalty, relate to broader considerations concerning the exercise of our sanctioning authority in the public interest. It is not inappropriate for us to make decisions based on such considerations without first giving all parties an opportunity to brief us on their views.[33/]

Accordingly, we have determined to impose a civil money penalty. We turn now to consideration of the amount of the penalty. The Act specifies maximum penalty amounts, and those specified amounts are from time to time subject to penalty inflation adjustments published in the Code of Federal Regulations. For conduct occurring after February 14, 2005 but before March 4, 2009 (the period encompassing Respondents' noncooperation before these proceedings were instituted), the Board is authorized to impose a civil money penalty of up to $800,000 for a natural person and up to $15.825 million for other persons in cases involving intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct.[34/]

In this case we have determined to impose a civil money penalty of $75,000. While this is well below the maximum penalty that we could impose, it nonetheless reflects the seriousness of Respondents' noncooperation, including the harm to investors from the possibility that such noncooperation may have prevented the Board from uncovering evidence that would have revealed failures or violations warranting an even steeper penalty. We also view it as sufficient to deter similar noncooperation by

[33/] As set out in PCAOB Rule 5460(c), the Board's review of an initial decision is de novo, and the Board may, among other things, modify that decision in whole or in part. The Board's ability to modify an initial decision is not conditioned on giving the parties a specific opportunity to brief each contemplated modification.

[34/] See Sections 105(c)(4)(D) and 105(c)(5) of the Act; 17 C.F.R. § 201.1003 Table III; PCAOB Rules 5300(b)(1) and 5300(a)(4). For sanctionable conduct in that same period that does not involve intentional or knowing (including reckless) conduct or repeated instances of negligent conduct, the Board is authorized to impose a civil money penalty of up to $110,000 for a natural person and $2.1 million for other persons.

others. Because the record indicates that REB is a sole proprietorship owned and controlled by Bassie, we impose a penalty solely on Bassie.

V.

For the reasons described above, we conclude that, in order to protect the interests of investors and to further the public interest, REB's PCAOB registration should be permanently revoked, Bassie should be permanently barred from associating with any registered public accounting firm,[35/] and a civil money penalty of $75,000 should be imposed against Bassie.[36/]

An appropriate order will issue.[37/]

By the Board.

[35/] Respondents' briefs reflect a concern that sanctions imposed by the Hearing Officer, and potentially imposed by the Board, include "denial of the property right of Respondent's CPA license." Respondents' Reply Brief at 6. We have no authority to reach, and our sanctions do not reach, any state or professional licenses held by Respondents. We note, however, that as required by Section 105(d) of the Act, a copy of this decision and the related order will be transmitted to the appropriate state regulator.

[36/] All funds collected by the Board as a result of the assessment of civil money penalties shall be used in accordance with Section 109(c)(2) of the Act.

[37/] We have considered all of the parties' contentions regarding the issue of noncooperation in connection with the Issuer B ABDs. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion. The Hearing Officer also granted summary disposition in favor of the Division with respect to other grounds for imposing sanctions against Respondents, and the parties have addressed those findings in their briefs. As to those matters, we have concluded that there are genuine issues of material fact that preclude resolution of the allegations on summary disposition. In light of the sanctions we are imposing, however, we are not at this time remanding those other aspects of the case or ordering further proceedings on any other aspects of the case.

PCAOB
Public Company Accounting Oversight Board

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of R.E. Bassie & Co. and R. Everett Bassie, CPA	PCAOB File No. 105-2009-001
Respondents.	ORDER IMPOSING SANCTIONS October 6, 2010

On the basis of the Board's opinion issued this day, it is

ORDERED that R. Everett Bassie is permanently barred from associating with any registered public accounting firm; and it is further

ORDERED that R.E. Bassie & Co.'s registration with the Board is permanently revoked; and it is further

ORDERED that R. Everett Bassie shall pay a civil money penalty in the amount of $75,000 by (a) United States postal money order, certified check, bank cashier's check, or bank money order, (b) made payable to the Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies R. Everett Bassie as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: J. Gordon Seymour, General Counsel and Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date: If a respondent does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against a respondent on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If a respondent files an application for review by the Commission or the Commission orders review of sanctions ordered against a respondent, the effective date of the sanctions ordered against that respondent shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board.

J. Gordon Seymour
Secretary

October 6, 2010

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Paul Gaynes	)	PCAOB File No. 105-2011-006
	)	**Notice of Finality of Initial Decision**
Respondent.	)	January 3, 2012

On November 10, 2011, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Paul Gaynes ("the Firm") be permanently revoked and that the Firm pay a civil money penalty in the amount of $5,000.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Paul Gaynes as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: J. Gordon Seymour, General Counsel and Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the

Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

J. Gordon Seymour /MJS
J. Gordon Seymour
Secretary

January 3, 2012

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In the Matter of Paul Gaynes,

Respondent.

PCAOB No. 105-2011-006

Hearing Officer –DMF

INITIAL DECISION (DEFAULT)

November 10, 2011

Summary

Respondent was held in default, pursuant to PCAOB Rule 5409(a), for failing to file an Answer in response to the Order Instituting Disciplinary Proceedings (OIP). The allegations in the OIP, which are deemed true and are supported by evidence in the record, establish that Respondent violated Section 102(d) of the Sarbanes-Oxley Act of 2002 (the Act) and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011, and violated Section 102(f) of the Act and Rule 2202 by failing to pay the annual fee for 2011. For these violations, pursuant to Sections 105(c)(4) and(c)(5) of the Act and PCAOB Rule 5300(a), Respondent's registration with the PCAOB is permanently revoked and Respondent is ordered to pay a civil money penalty in the amount of $5,000.

Appearances

David B. Florenzo, Esq., Washington, DC, for the Division of Enforcement and Investigations.

No appearance by or on behalf of Respondent Paul Gaynes.

DECISION

1. Introduction

On August 5, 2011, the Public Company Accounting Oversight Board (PCAOB or the Board) issued an Order Instituting Disciplinary Proceedings (OIP) alleging that Respondent Paul

Gaynes (Respondent) violated Section 102(d) of the Sarbanes-Oxley Act of 2002 (the Act) and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011, and violated Section 102(f) of the Act and Rule 2202 by failing to pay the annual fee for 2011. The OIP required that Respondent file an Answer to the OIP by September 15, 2011. The OIP was personally served on Respondent on August 9, 2011.

Respondent failed to file an Answer by September 15. On September 16, 2011, I issued an order directing Respondent to show cause why it should not be held in default, pursuant to Rule 5409(a)(2), for failing to file an Answer, and requiring Respondent to file its response to the order by September 26, 2011. The order to show cause warned Respondent that if it failed to file a response to the order within the time allowed, it would be held in default, and that if Respondent was held in default, a default decision might be issued finding that Respondent committed the violations alleged in the OIP and imposing sanctions.

Respondent did not file any response to the order to show cause by September 26, 2011. Accordingly, on September 27, 2011, I issued an order holding Respondent in default, pursuant to Rule 5409(a)(2), and directing the Division of Enforcement and Investigations (Division) to file a motion for issuance of a default decision, with appropriate supporting materials, by October 27, 2011. The Division filed its motion for entry of a default decision, with supporting materials, on October 25, 2011. For the following reasons, the Division's motion is granted.

2. Facts

The following statement of facts is based on the allegations in the OIP, which are deemed true, pursuant to Rule 5409(a), and the materials filed by the Division in support of its motion.[1]

[1] See James M. Russen, Jr., Exch. Act Rel. No. 32895, 51 S.E.C. 675, 678 n.12 (1993) ("The Association did not base its conclusion simply on the complaint's allegations; rather, it reviewed the record evidence presented by its staff and determined that the evidence supported a finding of violation. This approach affords this Commission a basis for discharging its review function under Section 19 of the Securities Exchange Act.").

Respondent is a proprietorship located in New York and is licensed to engage in the practice of public accounting under the laws of New York. At all relevant times, Respondent has been registered with the PCAOB pursuant to Section 102 of the Act.

Section 102(d) of the Act requires each registered public accounting firm to submit an annual report to the PCAOB "to provide to the Board such additional information as the Board or the [Securities and Exchange] Commission may specify," and Section 102(f) of the Act requires the PCAOB to assess and collect a registration fee and an annual fee from each registered public accounting firm "in amounts that are sufficient to recover the costs of processing and reviewing applications and annual reports." In accordance with these provisions, PCAOB Rule 2200 requires each registered public accounting firm to file an annual report with the PCAOB on Form 2, and Rule 2201 provides that the deadline for filing the Form 2 annual report is June 30 of each year. Rule 2202 requires that each registered public accounting firm "pay an annual fee to the Board on or before July 31 of any year in which the firm is required to file an annual report on Form 2."

Respondent failed to file an annual report on Form 2 for 2010 by June 30 of that year, as required by Rules 2200 and 2201. On December 17, 2010, PCAOB Division of Registration and Inspections (Registration) staff sent Respondent a "Charging Letter" alerting Respondent to its failure to file an annual report for 2010, and warning Respondent that if it did not either file its annual report or submit a Form 1-WD to withdraw from PCAOB registration by January 17, 2011, Registration would recommend that the Board institute a disciplinary proceeding against Respondent. On December 21, 2010, Respondent sent Registration staff an email stating that it "need[ed] real guidance on filing the annual report." Respondent indicated that it would telephone Registration staff to obtain such guidance. Nevertheless, Respondent failed to file its annual report for 2010. Further, although it had not filed its annual report for 2010, Respondent issued audit reports on the financial statements of four broker-dealers in February 2011.

Respondent also failed to file its annual report on Form 2 for 2011 by June 30 of this year, as required by Rules 2200 and 2201. In addition, Respondent failed to pay its annual fee for 2011 by July 31 of this year, as required by Rule 2202.

3. Discussion and Conclusions

The foregoing facts establish that Respondent violated Section 102(d) of the Act and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011, and violated Section 102(f) of the Act and Rule 2202 by failing to pay its annual fee for 2011, as alleged in the OIP.

The remaining issue is what sanctions should be imposed for those violations. The Division requests that Respondent's registration be permanently revoked.

The imposition of disciplinary sanctions is governed by Sections 105(c)(4) and (c)(5) of the Act. Pursuant to Section 105(c)(5), Respondent's registration may be permanently revoked only if Respondent's violations involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." In this case, the record demonstrates that Respondent was notified of its failure to file its 2010 annual report, and was given an opportunity to correct that failure by either submitting the report or withdrawing from PCAOB registration. Instead of following either course, Respondent issued audit reports for broker-dealers, and subsequently failed to file its 2011 annual report and failed to pay its 2011 annual fee. These facts are sufficient to demonstrate that Respondent's conduct satisfied the requirements of Section 105(c)(5).

I also find that the facts justify permanently revoking Respondent's registration. The annual report requirement is an integral part of the regulatory scheme established by the Act and the PCAOB's rules. In that regard, Form 2 requires each registered public accounting firm to provide updated information annually concerning, inter alia: (1) the firm's structure; (2) the firm's services, including those services related to the Act's registration requirement; (3) fees billed to audit clients by the firm; (4) audit reports issued by the firm, or as to which the firm played a substantial role; (5) any disciplinary history of persons associated with the firm; and (6) arrangements for the firm to receive consulting or certain other professional services. All of this information is highly relevant to the PCAOB's oversight of registered public accounting firms. By failing to file its annual reports, while continuing to issue audit reports for broker-dealers, Respondent has impeded the PCAOB's ability to fulfill its statutory mandate. Similarly, the annual fee imposed pursuant to the Act provides essential support for the PCAOB's annual report program.

I conclude, therefore, that a permanent revocation of Respondent's registration is an appropriate sanction. In addition, although the Division did not request the imposition of a civil money penalty, I find that such a penalty is appropriate in this case.

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has considered the factors set forth in Section 21B(c) of the Securities Exchange Act of 1934 (Exchange Act) as providing helpful and relevant guidance.

> The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or

> convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C. and Larry O'Donnell, CPA, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10.

In this case, Respondent's violations involved deliberate or reckless disregard of regulatory requirements, and there is a need to deter not only Respondent, but also other registered public accounting firms, from such conduct. In particular, I note that, in its Charging Letter, the Registration staff offered Respondent the opportunity to avoid disciplinary action by either filing its 2010 annual report or submitting a Form 1-WD withdrawing from PCAOB registration. Respondent followed neither course of action, but instead issued audit reports for several broker-dealers, and subsequently failed to file its 2011 annual report or to pay its 2011 annual fee. Under these circumstances, merely revoking Respondent's registration would not adequately protect the interests of investors or further the public interest.

Accordingly, I conclude that a $5,000 civil money penalty should be imposed to properly fulfill the Board's disciplinary and remedial responsibilities. While this amount is well below the maximum authorized by Sections 105(c)(4) and (c)(5) of the Act, it reflects the seriousness of Respondent's violations, under the standards set forth in Section 21B(c) of the Exchange Act, without being punitive.

4. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Section 105(c)(4) and (c)(5) of the Act and Rule 5300(a), that for violating Section 102(d) of the Act and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011, and for violating Section 102(f) of the Act and

Rule 2202 by failing to pay the annual fee for 2011, the registration of Respondent Paul Gaynes is permanently revoked and Respondent Paul Gaynes shall pay a $5,000 civil money penalty.

This Initial Decision shall become final in accordance with Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision in accordance with Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

David M. FitzGerald
Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Buckno Lisicky & Company, P.C. Respondent.	PCAOB File No. 105-2011-004 **Notice of Finality of Initial Decision** January 9, 2012

On November 17, 2011, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Buckno Lisicky & Company, P.C. ("the Firm") be suspended for one year and that the Firm pay a civil money penalty in the amount of $5,000.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Buckno Lisicky and Company, P.C. as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: J. Gordon Seymour, General Counsel and Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the

Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

J. Gordon Seymour
Secretary

January 9, 2012

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In the Matter of Buckno Lisicky & Company, P.C., Respondent.	PCAOB No. 105-2011-004 Hearing Officer – DMF **INITIAL DECISION** November 17, 2011

Summary

The Division of Enforcement and Investigations' motion for summary disposition, submitted in accordance with PCAOB Rule 5427, is granted. The undisputed facts establish that Respondent, a registered public accounting firm, violated Section 102(d) of the Sarbanes-Oxley Act of 2002 and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011. For those violations, pursuant to Sections 105(c)(4) and(c)(5) of the Act and PCAOB Rule 5300(a), Respondent's registration is suspended for one year and Respondent is ordered to pay a $5,000 civil money penalty.

Appearances

David B. Florenzo, Esq., Washington, DC, for the Division of Enforcement and Investigations.

Anthony J. Buczek, Shareholder, on behalf of Respondent Buckno Lisicky & Company, P.C.

DECISION

1. Procedural History

The Public Company Accounting Oversight Board (PCAOB or Board) issued the Order Instituting Disciplinary Proceedings (OIP) in this matter on August 5, 2011. The OIP alleges that Respondent Buckno Lisicky & Company, P.C. (Respondent), a registered public accounting firm, violated Section 102(d) of the Sarbanes-Oxley Act of 2002 (the Act) and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011. On September 15, 2011, the Hearing Office received a letter from Anthony J. Buczek, a shareholder of Respondent, which I deemed Respondent's Answer to the OIP (September 15 letter). In the September 15 letter, Buczek did not deny that Respondent had failed to file its 2010 and 2011 annual reports, but offered explanations for Respondent's failure to do so, along with supporting documents.

On October 3, 2011, I held a telephonic pre-hearing conference (Conference) with counsel for the Division of Enforcement and Investigations (Division) and Buczek, who appeared on behalf of Respondent. During the Conference, I discussed with the parties the allegations in the OIP, the explanations for Respondent's failure to file its annual reports set forth in the September 15 letter, and a procedure for resolving the charges in the OIP. In substance, it was agreed that the Division would file a motion for summary disposition, pursuant to PCAOB Rule 5427, by October 14, 2011, and that Respondent would file a response to the Division's motion by October 28, 2011, which might include an affidavit and additional documents supporting the explanations offered in the September 15 letter. It was further agreed that, for good cause, Respondent could file a request for additional time to respond to the Division's motion prior to the October 28 deadline. On October 3, I issued an order confirming the schedule and procedures discussed during the Conference.

The Division filed a motion for summary disposition on October 14, 2011, together with a supporting affidavit and exhibit.[1] In its motion, the Division requested that I issue an Initial

[1] The exhibit was a copy of an issuer's annual report, filed with the SEC on April 1, 2011, that included Respondent's audit report on the issuer's financial statements, also dated April 1, 2011. On November 10, 2011, the Division filed a motion to supplement the record by substituting an SEC-certified copy of the issuer's annual report for the uncertified copy filed with the Division's motion. Because the certified copy does not substantively alter the evidence supporting the Division's summary disposition motion, the Division's motion to supplement the record is granted.

Decision holding that Respondent violated Section 102(d) of the Act and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011, as alleged in the OIP, and that as sanctions for those violations, pursuant to Section 105(c)(4) of the Act, I suspend Respondent's registration with the PCAOB for one year and order Respondent to pay a $10,000 civil money penalty.

Respondent neither filed a response to the Division's motion for summary disposition by the October 28 deadline nor requested additional time to file a response. Nevertheless, considering that Respondent is not represented by counsel in this proceeding, and in light of the representations in Buczek's September 15 letter and the discussion during the Conference, I issued an order on November 4, 2011, extending the deadline for Respondent to file a response to the Division's summary disposition motion until November 11, 2011, and advising Respondent that if it failed to file a response to the Division's motion by that date, I would consider the Division's motion based on the existing record.

Respondent did not file any response to the Division's motion by the November 11 deadline. Rule 5421(c) provides: "Any allegation [in the OIP] not denied [in Respondent's Answer] shall be deemed admitted." Buczek's September 15 letter, which I deemed to be Respondent's Answer to the OIP, did not deny the allegations in the OIP; on the contrary, in substance Buczek admitted that Respondent was required to file annual reports for 2010 and 2011, but failed to do so until September 14, 2011, and asserted certain potentially mitigating circumstances related to Respondent's failures. During the Conference I advised Buczek that in responding to the Division's summary disposition motion, "any factual support that you want to offer [in support of mitigating circumstances] should be either documentary or in the form of an affidavit," and Buczek acknowledged that he understood that requirement. Respondent, however, did not submit any additional materials in response to the Division's motion.

Accordingly, for purposes of the Division's motion for summary disposition, the relevant record consists of the OIP; Buczek's September 15 letter, including the documents attached to the letter; the transcript of the Conference; the Division's motion for summary disposition; and the affidavit and exhibit submitted in support of the Division's motion. Upon consideration of those materials, I find, in accordance with Rule 5427(d), that there is no genuine issue as to any material fact and that the Division is entitled to a disposition in its favor as a matter of law. Therefore, the Division's motion for summary disposition is granted.

2. Facts

Respondent is a professional corporation located in Pennsylvania and is licensed to engage in the practice of public accounting under the laws of Pennsylvania. At all relevant times, Respondent has been registered with the PCAOB pursuant to Section 102 of the Act.

Section 102(d) of the Act requires each registered public accounting firm to submit an annual report to the PCAOB "to provide to the Board such additional information as the Board or the [Securities and Exchange] Commission may specify." In accordance with that provision, PCAOB Rule 2200 requires each registered public accounting firm to file an annual report with the PCAOB on Form 2, and Rule 2201 provides that the deadline for filing the Form 2 annual report is June 30 of each year. Respondent did not file an annual report for 2010 by June 30 of that year.

Respondent received a letter from the staff of the Division of Registration and Inspections dated December 17, 2010, regarding Respondent's failure to file its 2010 annual report, and Buczek sent the staff a reply letter dated February 2, 2011, on behalf of Respondent (February 2 letter). In the February 2 letter, Buczek stated that he "was under the belief" that Respondent's 2010 annual report had been filed. Buczek stated that around the time the annual report was due, his mother passed away and he was dealing with "a significant number of other family issues." As a result, Buczek's February 2 letter stated, he was "away from the office during normal working hours" and "had to enlist the help of supporting staff to complete the submission [of Respondent's 2010 annual report] but [Buczek] failed to confirm that the report was filed properly." Buczek stated that, "[i]f it is possible," he would "complete the [2010] annual report within the next five days but would need a new user name and password in order to do so."

In his September 15 letter, Buczek stated: "Subsequent to my February 2, 2011 letter ... on April 8, 2011 I was able to speak with someone at the PCAOB and obtain the correct user name and establish a new password needed to complete the annual reports for my firm." Buczek further stated that on April 21, 2011, he prepared both the 2010 and 2011 annual reports for Respondent on the PCAOB website, but forgot to electronically submit the documents, so they remained in draft status until, after receiving the OIP, he realized that the reports had not been submitted. On September 14, 2011, Buczek electronically submitted Respondent's 2010 and 2011 annual reports on the PCAOB website.

3. Discussion and Conclusions

It is undisputed that Respondent failed to file its annual reports for both 2010 and 2011 until September 14, 2011. Therefore, I conclude that Respondent violated Section 102(d) of the Act and Rule 2200, as charged in the OIP. The remaining issue is what sanctions should be imposed for Respondent's violations.

The annual report requirement is an integral part of the regulatory scheme established by the Act and the PCAOB's rules. In that regard, Form 2 requires each registered public accounting firm to provide updated information annually concerning, inter alia: (1) the firm's structure; (2) the firm's services, including those services related to the Act's registration requirement; (3) fees billed to audit clients by the firm; (4) audit reports issued by the firm, or as to which the firm played a substantial role; (5) any disciplinary history of persons associated with the firm; and (6) arrangements for the firm to receive consulting or certain other professional services. All of this information is highly relevant to the PCAOB's oversight of registered public accounting firms in accordance with the Act.

In its motion for summary disposition, the Division requests that Respondent's registration be suspended for one year. The imposition of disciplinary sanctions is governed by Sections 105(c)(4) and (c)(5) of the Act. Pursuant to Section 105(c)(5), Respondent's registration may be suspended, as the Division requests, only if Respondent's violations involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."

In his February 2 letter, Buczek asserted that Respondent's initial failure to submit its 2010 annual report was attributable to his reliance on Respondent's support staff to file the report, in light of his absence due to family matters, but admitted that he failed to follow up to ensure that the report had, in fact, been filed. Moreover, at least by the time of his February 2 letter, Buczek was aware that Respondent's 2010 annual report had not been filed with the PCAOB, and was more than seven months overdue.

In his February 2 letter, Buczek stated that he would attempt to file the annual report within five days, but in his September 15 letter he admits that he did not even obtain the necessary user name and password until April 8, 2011. After obtaining a user name and password, he failed to prepare draft annual reports for 2010 and 2011 until April 21, 2011. And even then, he failed to properly submit the annual reports until September 14, 2011. Moreover, during the period between Buczek's February 2 letter and his submission of Respondent's 2010 annual report, an issuer filed its annual report with the SEC that included Respondent's audit report, dated April 1, 2011, on the issuer's financial statements.[2]

Based on these undisputed facts, I find that Respondent's failures to timely file its 2010 and 2011 annual reports involved repeated instances of negligent conduct, each resulting in a violation of Section 102(d) of the Act and Rule 2200, and thus satisfy the requirements for the imposition of a suspension under Sections 105(c)(4) and (c)(5) of the Act. Further, I conclude that the one-year suspension requested by the Division is appropriate under the circumstances. As explained above, annual reports are an essential component of the PCAOB's oversight responsibilities, and thus Buczek's inattention to Respondent's obligations as a registered public accounting firm placed investors at risk by impeding the PCAOB's ability to fulfill its statutory duties. On the other hand, while the undisputed facts establish that Buczek's failures to file Respondent's annual reports were negligent, they are not sufficient to establish, for purposed of summary disposition, that the failures were attributable to intentional or reckless conduct.[3] A one-year suspension of Respondent's registration, therefore, appropriately addresses Respondent's violative conduct. I also note that by failing to respond to the Division's motion

[2] The OIP alleges, and Respondent has not denied, that "[p]ublic records indicate that [Respondent] issued one audit report for an issuer in 2011, one audit report for an issuer in 2010, one audit report for an issuer in 2009, two audit reports for issuers in 2008, and one audit report for an issuer in 2007." Because Respondent did not deny those allegations, they are deemed admitted, pursuant to Rule 5421(c).

[3] The Division argues that Respondent's conduct should be characterized as intentional or reckless, rather than negligent. "Recklessness in this context ... is an 'extreme departure from the standards of ordinary care, . . . which presents a danger' to investors or the markets 'that is either known to the (actor) or is so obvious that the actor must have been aware of it.'" Gately & Assocs., LLC, Exch. Act Rel. No. 62656, 2010 SEC LEXIS 2535, at *33 (Aug. 5, 2010) (quoting Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57,164, 57,166 (Oct. 26, 1998)). It is generally inappropriate to resolve issues regarding intent or state of mind through summary disposition, unless the appropriate resolution of such issues is clear based on the undisputed facts. In light of the extremely limited record in this proceeding, I do not find the undisputed facts sufficient to conclude that Respondent's conduct was intentional or reckless, rather than negligent.

for summary disposition, even after I extended the deadline for filing a response, Respondent waived its opportunity to argue for a shorter suspension.

The Division also requests that Respondent be ordered to pay a $10,000 civil money penalty. In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has considered the factors set forth in Section 21B(c) of the Securities Exchange Act of 1934 (Exchange Act) as providing helpful and relevant guidance.

> The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C. and Larry O'Donnell, CPA, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10.

The undisputed facts are not sufficient to establish that (1) Respondent's conduct was deliberate or reckless, rather than negligent; (2) there was actual harm to other persons resulting from Respondent's conduct; (3) there was any unjust enrichment; or (4) Respondent has previously been found to have committed any relevant violations. As explained above, however, Respondent's failure to file timely annual reports interfered with the PCAOB's ability to fulfill its oversight responsibilities and thus placed investors at risk. Although Respondent was aware that its 2010 annual report was long overdue, Respondent issued at least one audit report for an issuer, on which investors might reasonably have relied, before even attempting to file its overdue report.

Therefore, there is a clear need to deter Respondent, as well as other registered public accounting firms, from failing to comply with the annual reporting requirement in the future. Further, I conclude that a one-year suspension would not, by itself, be adequate to accomplish that goal; therefore, the imposition of a civil money penalty, in addition to the suspension, is appropriate. I find, however, that the $10,000 penalty proposed by the Division would be excessive. The Division's argument for a $10,000 penalty rests on its characterization of Respondent's conduct as deliberate or reckless; as explained in footnote 3 above, however, I do not find the record sufficient to support such a characterization of Respondent's conduct for purposes of summary disposition. Instead, treating Respondent's violations as involving repeated instances of negligent misconduct, I conclude that a $5,000 civil money penalty, coupled with the one-year suspension, will properly accomplish the Board's disciplinary and remedial goals. While the amount of the penalty is well below the maximum authorized by Sections 105(c)(4) and (c)(5) of the Act, it reflects the seriousness of Respondent's violations, under the standards set forth in Section 21B(c) of the Exchange Act, without being punitive.

4. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Section 105(c)(4) and (c)(5) of the Act and Rule 5300(a), that for violating Section 102(d) of the Act and PCAOB Rule 2200 by failing to file annual reports for 2010 and 2011, the registration of Respondent Buckno Lisicky & Company, P.C. is suspended for one year and Respondent Buckno Lisicky & Company, P.C. shall pay a $5,000 civil money penalty.

This Initial Decision shall become final in accordance with Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision in accordance with Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

David M. FitzGerald
Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of *Kenneth J. McBride*	PCAOB File No. 105-2012-007
Respondent.	**Notice of Finality of Initial Decision**
	May 7, 2013

On March 15, 2013, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Kenneth J. McBride ("the Firm") be permanently revoked and that the Firm pay a civil money penalty in the amount of $5,000.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Kenneth J. McBride as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the

Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

May 7, 2013

PCAOB
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In the Matter of Kenneth J. McBride,

Respondent.

PCAOB No. 105-2012-007

Hearing Officer – DMF

INITIAL DECISION (DEFAULT)

March 15, 2013

Summary

Respondent was held in default, pursuant to PCAOB Rule 5409(a), for failing to file an Answer in response to the Order Instituting Disciplinary Proceedings ("OIP"). The allegations in the OIP, which are deemed true and are supported by evidence in the record, establish that Respondent failed to file annual reports and to pay annual fees for the years 2010, 2011, and 2012, as required by Sections 102(d) and 102(f) of the Sarbanes-Oxley Act of 2002, as amended, ("the Act") and PCAOB Rules 2200 and 2202. For these violations, pursuant to Sections 105(c)(4) and 105(c)(5) of the Act and PCAOB Rule 5300(a), Respondent's registration with the PCAOB is revoked and Respondent is ordered to pay a civil money penalty in the amount of $5,000.

Appearances

Noah A. Berlin, Esq., Washington, DC, for the Division of Enforcement and Investigations.

No appearance by or on behalf of Respondent Kenneth J. McBride.

DECISION

1. Introduction

On December 11, 2012, the Public Company Accounting Oversight Board ("PCAOB" or the "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") alleging that

Respondent Kenneth J. McBride ("McBride") violated Section 102(d) of the Sarbanes-Oxley Act of 2002, as amended, (the "Act") and PCAOB Rule 2200 by failing to file annual reports for 2010, 2011, and 2012, and violated Section 102(f) of the Act and Rule 2202 by failing to pay annual fees for 2010, 2011, and 2012.

The OIP directed McBride to file an Answer to the allegations contained in the OIP within twenty (20) days after service of the OIP on McBride. On December 20, 2012, the Secretary filed a Notice of Service indicating that McBride was served with a copy of the OIP on December 12, 2012. Accordingly, McBride was required to file his Answer to the OIP by January 2, 2013.

McBride failed to file an Answer to the OIP by the January 2, 2013, deadline. On January 8, 2013, I issued an order directing McBride to show cause why he should not be held in default, pursuant to Rule 5409(a)(2), for failing to file an Answer, and requiring McBride to file his response to the order by January 22, 2013. The order to show cause warned McBride that if he failed to file a response to the order within the time allowed, he would be held in default, and that if he was held in default, a default decision might be issued finding that McBride committed the violations alleged in the OIP and imposing sanctions.

McBride did not file any response to the order to show cause by January 22, 2013. Accordingly, on January 24, 2013, I issued an order holding McBride in default, pursuant to Rule 5409(a)(2), and directing the Division of Enforcement and Investigations ("Division") to file a motion for issuance of a default decision, with appropriate supporting materials, by February 25, 2013. The Division filed its motion for entry of a default decision, with supporting materials, on February 25, 2013. McBride did not file any response to the motion. For the following reasons, the Division's motion is granted.

2. Violation

The relevant facts are established by the allegations in the OIP, which are deemed true, pursuant to Rule 5409(a), and the materials filed by the Division in support of its motion, which substantiate and expand upon the OIP's allegations.[1] McBride operates a sole proprietorship located in Cold Spring Harbor, New York, and is licensed to engage in the practice of public accounting under the laws of New York. McBride registered with the Board on February 23, 2010, pursuant to Section 102 of the Act and Board rules. A search of public filings indicates that McBride issued one broker-dealer report dated February 25, 2009 for an audit period ending December 31, 2008.

Pursuant to Section 102(d) of the Act and Rules 2200 and 2201, each registered public accounting firm is required to submit an annual report to the PCAOB on Form 2 by June 30 of each year. In addition, pursuant to Section 102(f) of the Act and Rule 2202, each registered public accounting firm must pay an annual fee to the Board by July 31 of each year. McBride failed to file an annual report or to pay an annual fee in 2010, 2011, and 2012.

These facts are sufficient to establish that McBride violated Sections 102(d) and 102(f) of the Act and Rules 2200 and 2202, as alleged in the OIP.

3. Sanctions

The remaining issue is what sanctions should be imposed for those violations. The imposition of disciplinary sanctions is governed by Sections 105(c)(4) and 105(c)(5) of the Act. To justify a suspension or revocation of McBride's registration, McBride's violations must have involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of

[1] See James M. Russen, Jr., Exch. Act Rel. No. 32895, 51 S.E.C. 675, 678 n.12 (1993) ("The Association did not base its conclusion simply on the complaint's allegations; rather, it reviewed the record evidence presented by its staff and determined that the evidence supported a finding of violation. This approach affords this Commission a basis for discharging its review function under Section 19 of the Securities Exchange Act.").

negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." On the other hand, a civil money penalty may be imposed without such a finding, so long as the penalty does not exceed the amount set forth in Section 105(c)(4)(D)(i) of the Act, as adjusted. The Division requests that McBride's registration be suspended for a period of one year and that he be ordered to pay a civil money penalty of $5,000.

The materials submitted by the Division in support of its motion for a default decision establish that, prior to the institution of these proceedings, the Division made numerous attempts to notify McBride of his failure to timely file annual reports or pay annual fees. From July 19, 2010, through September 15, 2011, PCAOB staff sent both emails to the email address used in McBride's application for registration and correspondence by Federal Express to the address used in McBride's registration application ("Registered Address") in an effort to alert McBride to his failure to file his 2010 and 2011 annual reports and to pay his 2010 and 2011 annual fees. At least one of the emails and all of the correspondence was returned as undeliverable.

The Division subsequently sent McBride a charging letter dated July 12, 2012, concerning McBride's failure to timely file his 2011 annual report and pay his 2011 annual fee. The charging letter was sent to an address that the Division determined was McBride's current mailing address and it was delivered successfully. The charging letter described the basis for disciplinary proceedings against McBride as a result of his delinquencies, and offered McBride three options: become compliant by filing an annual report and paying the annual fee for 2011; submit a Form 1-WD, pursuant to Rule 2107, to withdraw from Board registration; or submit a statement of position as to why the firm should not be charged in a disciplinary proceeding. The charging letter also indicated that the Division would not recommend that the Board institute disciplinary proceedings if either of the first two options was performed by August 2, 2012.

Division staff received a telephone call from McBride on the morning of July 19, 2012, in which he indicated that he had received the charging letter and intended to file a Form 1-WD to withdraw from registration, the second option described in the July 12, 2012, charging letter, in order to avoid disciplinary action by the Board. Division staff directed McBride to the PCAOB's website for filing instructions, and gave McBride an e-mail address to contact in case he had any questions about the Form 1-WD submission process.

After more than a month passed without McBride undertaking any of the three options described in the July 12, 2012, charging letter, Division staff sent McBride a follow-up letter, dated August 27, 2012, which was delivered. The letter noted that McBride had failed to submit a Form 1-WD by August 2, 2012, and asked McBride to do so immediately. The letter further warned that McBride's failure to submit a Form 1-WD, or take any of the other actions described in the charging letter, might result in the Division recommending that the Board institute a disciplinary proceeding against him.

The Board instituted these proceedings on December 11, 2012, and the OIP was served on McBride on December 12, 2012. On or about December 17, 2012, McBride contacted Division staff to begin settlement negotiations. On January 9, 2013, after I issued the order requiring McBride to show cause why he should not be held in default, he contacted Division counsel again, indicating that he would endeavor to make his delinquent annual report filings, pay his delinquent annual fees, and file a Form 1-WD. As of the date of the Division's motion, however, Respondent had not taken any of those actions.

These facts are sufficient to establish that McBride's conduct meets the requirements of Section 105(c)(5) of the Act. When he voluntarily registered with the Board, McBride accepted the responsibility of every registered public accounting firm to file annual reports and pay annual fees; his failure to either file an annual report or pay an annual fee for three consecutive years reflects, at a minimum, repeated instances of negligent conduct each constituting a violation of the Act and the Board's rules.

After registering, McBride apparently changed his email and post office addresses without advising the Board. As a result, PCAOB staff's initial efforts to contact him about his delinquencies were unsuccessful. Ultimately, however, McBride was notified and given options that would have allowed him to avoid disciplinary action, yet after representing that he would file a Form 1-WD to withdraw from registration, he failed to do so. After this proceeding was filed, McBride represented to the Division that he would file his delinquent reports, pay his delinquent annual fees, and file a Form 1-WD, but failed to do so. These facts are sufficient to establish that, after receiving actual notice of his delinquencies, McBride's failure to file his past-due annual reports and to pay his past-due annual fees constituted intentional or knowing conduct within the meaning of Section 105(c)(5).[2]

In light of these facts, I conclude that the one-year suspension recommended by the Division would be insufficient to address McBride's violations. The violations continued for several years, even after McBride was given options for curing them, which indicates that McBride is unwilling or unable to conform his conduct to PCAOB requirements. Moreover, when McBride advised the staff on several occasions that he planned to take action to cure his violations, he consistently indicated that he intended to file a Form 1-WD to withdraw from registration, which indicates a lack of interest in continuing to be a registered public accounting

[2] I have considered in that regard McBride's statements to the Division indicating that he had been undergoing treatment for prostate cancer. According to the Division, however, McBride never asserted that his medical condition prevented him from filing his annual reports or paying his annual fees, and at the time of his representation to the Division on January 9, 2013, that he would endeavor to file his overdue annual reports and to pay his overdue annual fees, he advised the Division that his condition was cured or in remission. In the absence of some evidence that his medical condition interfered with his ability to file his annual reports and to pay his annual fees, or to cure his delinquencies in that regard, I find it irrelevant to the sanctions issue.

firm. Finally, his failure to participate in this proceeding also indicates that McBride lacks the intent or ability to conform to the Board's requirements. Accordingly, I conclude that McBride's registration should be revoked.

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has considered the factors set forth in Section 21B(c) of the Securities Exchange Act of 1934 ("Exchange Act") as providing helpful and relevant guidance.

> The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C., PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10 (footnotes omitted). The Securities and Exchange Commission has confirmed that "[a]n analysis based on Section 21B is … sufficiently flexible to be used in this context." R.E. Bassie & Co., Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

In this case, McBride's conduct initially involved repeated instances of negligent disregard of his obligations as a registered public accounting firm, and ultimately an intentional disregard of his obligation to cure his deficiencies, even when offered alternatives that would have allowed him to avoid disciplinary action. Further, by failing to pay his annual fees, McBride has, in effect, unjustly enriched himself. Finally, there is a need to deter not only

McBride, but also other registered public accounting firms, from such conduct. On the other hand, there is no evidence of harm to other persons or of any prior misconduct on the part of McBride.

Taking all the relevant circumstances into consideration, I conclude that the $5,000 civil money penalty sought by the Division is appropriate to accomplish the Board's remedial objectives in this proceeding.

4. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Section 105(c)(4) and (c)(5) of the Act and Rule 5300(a), that for violating Section 102(d) of the Act and PCAOB Rule 2200 by failing to file annual reports for 2010, 2011 and 2012, and for violating Section 102(f) of the Act and Rule 2202 by failing to pay an annual fee for 2010, 2011 and 2012, the registration of Respondent Kenneth J. McBride is permanently revoked and Respondent Kenneth J. McBride shall pay a civil money penalty in the amount of $5,000.

This Initial Decision shall become final in accordance with Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision in accordance with Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

David M. FitzGerald
Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of *Eric C. Yartz, P.C.*

Respondent.

PCAOB File No. 105-2012-006

Notice of Finality of Initial Decision

May 7, 2013

On March 15, 2013, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Eric C. Yartz, P.C. ("the Firm") be suspended for one year and that the Firm pay a civil money penalty in the amount of $2,500.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Eric C. Yartz, P.C. as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the

Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

May 7, 2013

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In the Matter of Eric C. Yartz, P.C.,

Respondent.

PCAOB No. 105-2012-006

Hearing Officer – DMF

INITIAL DECISION

March 15, 2013

Summary

The Division of Enforcement and Investigations' motion for summary disposition, submitted in accordance with PCAOB Rule 5427, is granted; Respondent's cross-motion for summary disposition is denied. The undisputed facts establish that Respondent, a registered public accounting firm, violated Section 102(d) of the Sarbanes-Oxley Act of 2002, as amended, ("the Act") and PCAOB Rule 2200 by failing to timely file annual reports for 2010, 2011, and 2012 and Section 102(f) of the Act and Rule 2202 by failing to timely pay annual fees for 2010, 2011, and 2012. For those violations, pursuant to Sections 105(c)(4) and 105(c)(5) of the Act and PCAOB Rule 5300(a), Respondent's registration is suspended for one year and Respondent is ordered to pay a $2,500 civil money penalty.

Appearances

Noah A. Berlin, Esq., Washington, DC, for the Division of Enforcement and Investigations.

Eric C. Yartz, Owner, on behalf of Respondent Eric C. Yartz, P.C.

DECISION

1. Background

On December 11, 2012, pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002, as amended, ("the Act"), the Public Company Accounting Oversight Board ("PCAOB" or "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") against Eric C. Yartz, P.C., ("Respondent"), a registered public accounting firm. The OIP set forth the allegations of the Division of Enforcement and Investigations ("Division") that Respondent violated Section 102(d) of the Act and PCAOB Rule 2200 by failing to file its annual reports for 2010, 2011, and 2012, and that Respondent violated Section 102(f) of the Act and PCAOB Rule 2202 by failing to pay its annual fees for the same years.

Respondent filed its Answer on December 21, 2012, generally denying the allegations in the OIP. On January 10, 2013, the Division submitted a proposed schedule, agreed to by Respondent, under which the Division would file a motion for summary disposition, pursuant to Rule 5427. The schedule contemplated that if I denied the Division's motion, I would hold a pre-hearing conference and establish a more complete pre-hearing schedule at a later date.

The Division filed its motion for summary disposition and supporting materials on February 4, 2013. On February 21, 2013, Respondent filed a response to the Division's motion and supporting materials in which Respondent cross-moved for summary disposition in its favor. For the reasons set forth below, the Division's motion is granted and Respondent's cross-motion is denied.

2. Summary Disposition Standards

Rule 5427(d) provides that "[t]he hearing officer shall promptly grant a motion for summary disposition if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a disposition as a matter of law." Rule 5427(d) "mirrors the summary judgment standard in Rule 56 of the Federal Rules of Civil Procedure, and accordingly federal court interpretations of Rule 56 are instructive in interpreting the Board rule." Gately & Assocs.

LLC, Exch. Act. Rel. No. 62656, 2010 WL 3071900 at *7 (SEC Aug. 5, 2010) (footnote omitted).

In considering a motion for summary disposition, the ultimate question is whether the record as a whole demonstrates the existence of any factual disputes that must be resolved through a hearing. "[A] party seeking summary judgment [must] make a preliminary showing that no genuine issue of material fact exists. Once the movant has made this showing, the nonmovant must contradict the showing by pointing to specific facts demonstrating that there is, indeed, a trialworthy issue." National Amusements, Inc. v. Town of Dedham, 43 F.3d 731, 735 (1st Cir. 1995).

To preclude summary disposition, any unresolved factual issues must be both genuine and material – "the mere existence of some alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no genuine issue of material fact." Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247-48 (1986) (emphasis in original). In considering a motion for summary disposition, the record will be viewed most favorably to the nonmoving party, but the adjudicator "need not credit purely conclusory allegations, indulge in rank speculation, or draw improbable inferences." National Amusements, 43 F.3d at 735. "Where the record taken as a whole could not lead a rational trier of fact to find for the nonmoving party, there is no 'genuine issue for trial.'" Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986) (quoting Fed. R. Civ. P. 56(e)).

3. Violations

The facts establishing Respondent's violations are undisputed. Respondent is a professional corporation located in Houston, Texas. Eric C. Yartz ("Yartz") is Respondent's only associated person. Operating as a sole proprietorship, Yartz issued an audit report for an issuer in 2003, without being registered with the PCAOB. Yartz subsequently applied for PCAOB registration in 2004, but, pursuant to a settlement agreement, the Board disapproved his application, because of his issuance of an audit report for an issuer without being registered. The Texas State Board of Public Accountancy reprimanded and disciplined Yartz for the same conduct.

In 2006, Respondent applied for registration and its application was approved by the Board. Respondent's registration was effective March 14, 2006, and at all relevant times, Respondent was registered with the Board. Pursuant to Section 102(d) of the Act and PCAOB Rules 2200 and 2201, each registered public accounting firm must submit an annual report to the PCAOB by June 30 of each year. In addition, pursuant to Section 102(f) of the Act and Rule 2202, each registered public accounting firm must pay an annual fee to the PCAOB by July 31 of each year. Respondent, however, failed to file annual reports by June 30, 2010, June 30, 2011, and June 30, 2012. Respondent also failed to pay annual fees by July 31, 2010, July 31, 2011, and July 31, 2012. In 2013, subsequent to the Division's filing of its motion for summary disposition, Respondent filed its past-due annual reports, paid its past-due annual fees, and filed a Form 1-WD, pursuant to Rule 2107, to withdraw from PCAOB registration, which remains pending before the Board, pursuant to Rule 2107(e).

The undisputed facts, therefore, establish that Respondent violated Sections 102(d) and 102(f) of the Act and Rules 2200 and 2202 by failing to timely file its annual reports and failing to timely pay its annual fees for 2010, 2011, and 2012.[1] Indeed, in its response to the Division's

[1] The OIP charged Respondent with failing to file the annual reports and to pay the annual fees. Because Respondent has now submitted its annual reports and paid its annual fees, the violations are properly characterized as failures to timely file the annual reports and to timely pay the annual fees.

motion, Respondent states: "Respondent acknowledges that it mistakenly failed to timely file an annual report in 2010, 2011, and 2012 …."[2]

Accordingly, I conclude that the Division is entitled to a disposition as a matter of law that Respondent violated Sections 102(d) and 102(f) of the Act and PCAOB Rules 2200 and 2202.

4. Sanctions

The remaining issue is whether summary disposition is appropriate as to sanctions in this case, and, if so, what sanctions are appropriate. The imposition of disciplinary sanctions is governed by Sections 105(c)(4) and 105(c)(5) of the Act. Pursuant to Section 105(c)(5), Respondent's registration may be suspended or revoked only if Respondent's violations involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." On the other hand, a civil money penalty may be imposed without such a finding, so long as the penalty does not exceed the amount set forth in Section 105(c)(4)(D)(i) of the Act, as adjusted.

The Division requests, as sanctions for Respondent's violations, that its registration be suspended for one year and that it be ordered to pay a civil money penalty in the amount of $7,500. Respondent asserts: "Respondent agrees that a suspension and/or bar from registration with the Board for a period of one year is warranted. Respondent strongly believes that no civil money penalty is warranted. Material facts are in dispute. Respondent acknowledges that it mistakenly failed to timely file an annual report in 2010, 2011, and 2012, and further mistakenly

[2] In fact, Respondent states that "Respondent has admittedly never filed an annual report or paid any dues since Respondent initially registered with the Board."

failed to pay an annual fee for those periods, but that said omissions were a good faith mistake and not willful or reckless."

Although Respondent does not oppose the imposition of the one-year suspension requested by the Division, such a sanction cannot be imposed unless, first, Respondent's conduct satisfies the requirements of Section 105(c)(5), and, second, the requested suspension appears to be an appropriate, remedial sanction to address Respondent's conduct. The Division contends that "Respondent's conduct here was intentional, reckless, or repeatedly negligent, at the very least." To support that contention, the Division relies primarily on undisputed evidence that the Division of Registration and Inspections ("Registration"), initially, and the Division, subsequently, repeatedly attempted to notify Respondent, by email and correspondence, that it was delinquent in filing its annual reports and in paying its annual fees. The emails were sent to the email address used in Respondent's application for registration and the letters were sent by Federal Express to the address listed in Respondent's application for registration. Registration and the Division received receipts for all of the letters with indications that they had been delivered to Respondent. Nevertheless, neither Registration nor the Division received any response from Respondent until after the OIP was served on Respondent.

Notwithstanding the communications sent by Registration and the Division, Respondent's response to the Division's motion states: "Under penalties of perjury, Respondent, without qualification, swears that it had no knowledge of a continuing reporting or dues paying obligation to the PCAOB" (emphasis in original). Respondent asserts: "Respondent's first knowledge of this proceeding, and the underlying infractions, occurred when it received [the Division's] email containing the Complaint."

Respondent further asserts that, although it registered to perform audits of public companies in 2006, it also "purposefully and voluntarily ceased issuing audit reports of any kind-public, private, exempt - in 2006, specifically and in direct response to" a proceeding brought against Yartz, and other accounting firms by the Securities and Exchange Commission for issuing audit reports for issuers without being registered." Respondent states:

> Respondent has one CPA, owner Eric C. Yartz. Respondent recognized in 2006 that it more than likely could not adequately discharge its responsibilities under Board rules, and that continuing to audit public companies is not "in the best interest of investors" nor does it "further the public interest". So it quit. And, for good measure, ceased auditing non-public entities as well. Respondent honestly believed that because it limits its practice to tax compliance, it had no further responsibilities to the PCAOB or the SEC. Respondent was simply unaware of the requirement to file Form 1-WD [to withdraw from registration], until it received notice of the present action and contacted the Division's attorney. [Footnote omitted.]

With regard to the email communications sent by Registration and the Division, Respondent stated in its Answer to the OIP that "PCAOB is on Respondent's Junk e-mail list." With regard to the correspondence, Respondent asserts that it was misaddressed to Suite 310 in the building where Respondent maintains its office—the suite number listed in Respondent's application for registration—rather than to Suite 100, where Respondent's office is currently located. Respondent suggests in its cross-motion that "there is a likelihood someone other than Respondent's Owner signed for those letters." Respondent also states: "However, as embarrassing as it appears in hindsight, even if Respondent received said correspondence, they would have been treated as junk mail under the assumption that after four years of no communication, what substantive issue could the PCAOB possibly have with Respondent."

The first question posed is whether Respondent's assertions establish the existence of genuine issues of material fact regarding whether Respondent's conduct satisfies the requirements of Section 105(c)(5). If so, the Division's motion must be denied as to its request that Respondent's registration be suspended. In this case, however, I conclude that the undisputed facts are sufficient to support a conclusion that Respondent's conduct amounted to "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."[3]

There is no dispute that Respondent voluntarily registered with the Board. By doing so, Respondent accepted the duties and responsibilities of a registered public accounting firm, including the obligations to file annual reports and to pay annual fees. Respondent's admitted failure to inform itself of these obligations is not exculpatory; rather, it demonstrates that Respondent's failure to timely file its annual reports and to pay its annual fees for 2010, 2011, and 2012 was attributable to repeated instances of negligent conduct, each resulting in a violation of the Act and the Board's rules.

Further, there is no dispute that Registration and the Division made numerous efforts to notify Respondent of its delinquencies and the potential consequences for those delinquencies, and that the communications sent by Registration and the Division conveying those notifications were delivered. While Respondent asserts that it did not learn of its delinquencies until it received the OIP instituting this proceeding, there is no dispute that Respondent failed to update its address with the PCAOB. Respondent also asserts that it put the PCAOB on its junk email list and that PCAOB correspondence, if delivered, would have been treated as junk mail. These facts are aggravating, not mitigating, in determining the appropriate sanctions for Respondent's violations.

[3] The Division argues that Respondent's conduct should be characterized as intentional or reckless. "Recklessness in this context ... is an 'extreme departure from the standards of ordinary care, . . . which presents a danger' to investors or the markets 'that is either known to the (actor) or is so obvious that the actor must have been aware of it.'" Gately & Assocs., LLC, Exch. Act Rel. No. 62656, 2010 SEC LEXIS 2535, at *33 (Aug. 5, 2010) (quoting Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57,164, 57,166 (Oct. 26, 1998)). It is generally inappropriate to resolve issues regarding intent or state of mind through summary disposition, unless the appropriate resolution of such issues is clear based on the undisputed facts, which I do not find to be the case here.

I find, therefore, that, even accepting all of Respondent's assertions as true for present purposes, the undisputed facts are sufficient to establish that Respondent's violations entailed repeated instances of negligent conduct, each of which violated applicable PCAOB rules. Accordingly, the one-year suspension requested by the Division and not opposed by Respondent will be imposed.[4]

As explained above, a civil money penalty may be imposed under Section 105(c)(4)(D) of the Act without a finding that Respondent's violations involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has considered the factors set forth in Section 21B(c) of the Securities Exchange Act of 1934 ("Exchange Act") as providing helpful and relevant guidance.

> The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C., PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10 (footnotes omitted). The Securities and Exchange Commission ("Commission") has confirmed that "[a]n analysis based on Section 21B is … sufficiently flexible to be used in this context." R.E. Bassie

[4] I have considered whether a shorter or longer suspension, or a permanent revocation, of Respondent's registration would be a more appropriate sanction, and conclude that the one-year suspension is appropriately remedial in light of the undisputed facts.

& Co., Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

The Division argues that two of these factors are applicable here. The Division points to the fact that Respondent was previously sanctioned by the Commission for issuing an audit report for an issuer without being registered, and urges that a civil money penalty is required to deter Respondent and others from ignoring their responsibility, as registered firms, to file annual reports and to pay annual fees. Further, the Division contends that Respondent's conduct justifies the imposition of a civil money penalty greater than the $5,000 penalties imposed in Paul Gaynes, PCAOB No. 105-2011-006, Initial Decision (Nov. 10, 2011) and Buckno Lisicky & Company, P.C., PCAOB No. 105-2011-004, Initial Decision (Nov. 17, 2011). Respondent, on the other hand, argues that no penalty, in any amount, should be imposed.

In both Paul Gaynes and Buckno Lisicky & Company, P.C., there was undisputed evidence that the respondent was aware of its obligations to file annual reports, but failed to do so. More importantly, in both those cases the respondent had issued audit reports for issuers during the periods for which it failed to file annual reports. In contrast, Respondent has not performed any audits of public companies since registering with the Board. Further, in those cases, the respondents never filed their annual reports or paid their annual fees, whereas Respondent has recently filed its overdue reports and paid its overdue annual fees.

The facts in this case are more akin to those in Baumgarten & Company LLP, PCAOB Rel. No. 105-2013-001 (Feb. 21, 2013), where the Board approved the settlement of a disciplinary proceeding in which the respondent had failed to file annual reports and to pay annual fees for 2010, 2011, and 2012. As in this case, the respondent filed its overdue annual reports, paid its overdue annual fees, and filed a Form 1-WD after an OIP was issued. The settlement imposed a censure and a $2,000 civil money penalty on the respondent. See also Reuben E. Price & Co., Public Accountancy Corp., PCAOB Rel. No. 105-2011-008 (Dec. 20, 2011) (settlement imposing censure and $2,000 civil money penalty for failure to timely file annual reports and to pay annual fees for 2010 and 2011; reports filed, fees paid, and Form 1-WD submitted after OIP issued); GLO CPAs, LLLP, PCAOB Rel. No. 105-2011-006 (Nov. 30, 2011) (settlement imposing censure and $1,000 civil money penalty for failure to timely file annual reports for 2010 and 2011 and to timely pay an annual fee for 2011; reports filed, fee paid, and Form 1-WD submitted after OIP issued).

Of course, "the appropriate sanction depends on the facts and circumstances of each case and cannot be precisely determined by comparison with action taken in other proceedings. This is especially true with regard to settled cases, where … pragmatic factors may result in lesser sanctions." Anthony A. Adonnino, 56 S.E.C. 1273, 1295 (2003) (footnotes omitted). Thus, the settlements approved by the Board do not require, or dictate the amount of, civil money penalties in this case.

In that regard, I note that Respondent's violations, while not involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement did involve negligent disregard of Respondent's obligations as a registered public accounting firm over an extended period. Further, Respondent failed to fulfill those obligations notwithstanding the prior actions by the Board, the Commission, and the Texas State Board of Public Accountancy against Yartz, Respondent's owner and sole professional, for auditing a public company without being registered. There is, moreover, a need to properly deter Respondent and other registered public accounting firms from similar failures to fulfill their obligations. Considering all these circumstances, I conclude that a civil money penalty in the amount of $2,500 will appropriately accomplish the Board's remedial goals.

5. Order

For the foregoing reasons, **IT IS ORDERED**, that the Division's motion for summary disposition is granted, and that Respondent's cross-motion for summary disposition is denied.

IT IS FURTHER ORDERED that, pursuant to Section 105(c)(4) and (c)(5) of the Act and Rule 5300(a), for violating Section 102(d) of the Act and PCAOB Rule 2200 by failing to timely file its annual reports for 2010, 2011, and 2012, and for violating Section 102(f) of the Act and Rule 2202 by failing to timely pay its annual fees for 2010, 2011, and 2012, the registration of Respondent Eric C. Yartz, P.C., is suspended for one year and Respondent Eric C. Yartz, P.C., shall pay a $2,500 civil money penalty.

This Initial Decision shall become final in accordance with Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision in accordance with Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

David M. FitzGerald
Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of S.W. Hatfield, CPA
and Scott W. Hatfield, CPA

Respondents

PCAOB File No. 105-2009-003

FINAL DECISION

February 8, 2012

Appearances

Michael Plotnick, Esq., and Phillip J. Berkowitz, Esq., Washington, DC, for the Division of Enforcement and Investigations.

John A. Koepke, Jackson Walker LLP, Dallas, TX, for Respondents.

I.

S.W. Hatfield, C.P.A. (the "Firm"), a registered public accounting firm, and Scott W. Hatfield ("Hatfield") appeal from a hearing officer's decision revoking the Firm's registration with the Board, with a right to reapply after three years; barring Hatfield from association with any registered public accounting firm, with a right to petition to terminate the bar after three years; and imposing a civil money penalty of $50,000 jointly and severally on Hatfield and the Firm (collectively, "Respondents"). The hearing officer issued his decision after holding a hearing and finding that Respondents violated PCAOB Rules 3100 and 3200T in several respects in connection with their audits of two public companies. We base our findings on a *de novo* review of the record, except as to those findings not challenged on appeal. Like the hearing officer, we find that Respondents violated Rules 3100 and 3200T. Because of that conduct, we permanently revoke the Firm's registration and permanently bar Hatfield from association with a registered public accounting firm.

II.

The Firm is a public accounting firm organized as a sole proprietorship and licensed under Texas law to engage in the practice of public accounting. The Firm is registered with the PCAOB pursuant to Section 102 of the Act and PCAOB rules. Hatfield, the Firm's sole owner and employee, is a certified public accountant licensed in Texas. At all relevant times Hatfield has been a person associated with a registered public accounting firm, as defined in Section 2(a)(9) of the Act and PCAOB rules.

On January 9, 2009, the Board issued an Order Instituting Disciplinary Proceedings alleging that Respondents violated PCAOB rules and auditing standards in connection with their audits of the 2004 and 2005 financial statements of Epicus Communications Group, Inc. ("Epicus"), and the 2003 financial statements of Bidville, Inc. ("Bidville"). Respondents filed an Answer on February 16, 2009. A hearing was held on July 28 and 29, 2009, and the hearing officer issued his decision on December 16, 2009. Respondents petitioned for review. Briefing concluded on May 18, 2010, and oral argument before the Board was held on July 27, 2010.

A. The Epicus Audits

During the relevant period, Epicus was a Florida corporation, the common stock of which was registered with the Securities and Exchange Commission ("SEC") and quoted on the OTC Bulletin Board and the Pink Sheets. Epicus was an issuer, as defined in Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii). Epicus was a holding company and during the relevant period its only active business was the resale of telecommunication services through a subsidiary. Respondents were Epicus's auditors from 2002 through 2007, and, as is relevant to this proceeding, issued unqualified audit opinions on Epicus's financial statements for fiscal years 2004 and 2005. The audit reports containing those opinions were filed with the SEC in Epicus's annual Forms 10-KSB for 2004 and 2005.

1. FY 2004 Revenue Recognition

Facts

In FY 2004, Epicus offered three types of telephone service: local, which was billed monthly in advance of service, on a flat-rate basis; long distance, which was billed monthly after service was provided, based on calls made; and bundled, combining unlimited local and long distance service, which was billed monthly in advance of service, on a flat rate basis. Epicus's combined reported revenue for FY 2004 was approximately $25 million.

During the audit of Epicus's FY 2003 financial statements, which are not at issue here, Respondents determined, and notified Epicus, that its revenue recognition policy did not comport with GAAP. Respondents determined that GAAP required Epicus to recognize the income from telephone services at the time they were provided to its customers. Instead, Epicus recognized revenue when it billed its services to customers, which was before local and bundled services were provided, and after long distance service was provided.

Respondents recommended that Epicus change its policy to conform with GAAP by recognizing revenue for local and bundled services over each customer's billing period on a per-day basis, as the revenue was earned, and recognizing revenue for long distance service when it was provided. At the time of their audit of Epicus's FY 2004 financial statements, however, Respondents knew that Epicus had not changed its revenue recognition policy.

The OIP alleged that in their audit of Epicus's FY 2004 financial statements, Respondents failed to evaluate whether Epicus's revenue recognition policy caused its financial statements to be materially misstated under GAAP. At the hearing, Hatfield acknowledged that Respondents' work papers do not include any indication that they performed such an evaluation, but he testified that, in fact, during the audit he "did a visual and mental check," and "kind of just rough in [his] mind [he] looked to see where the difference was." Based on this, he "did not believe at that time that [Epicus's policy] would significantly misstate or distort the financial statements."

Also at the hearing, Respondent offered the testimony of an expert who attempted to duplicate Hatfield's claimed "visual and mental check." Respondents' expert created a written analysis that he described as "what a work paper, if required, might have looked like to assure the experienced auditor that there was not a material difference by not having the revenue recognition technically in accordance with GAAP." The analysis included detailed calculations purporting to quantify the maximum amount of the misstatement attributable to Epicus's non-GAAP policy, an amount that exceeded the planning materiality and tolerable misstatement thresholds that Respondents had set for the audit. In spite of this, the expert stated that, in his opinion, the misstatement amount he had calculated would not have been material. He based his opinion on a materiality evaluation that calculated the effect of the misstatement on Epicus's reported earnings per share—a different materiality analysis than that used by Respondents in the work papers.

The expert's written analysis, however, was incomplete and relied on unsupported assumptions. In calculating the maximum amount of the potential misstatement, he considered only Epicus's revenue for local service, ignoring Epicus's revenues for bundled and long distance services. Furthermore, the expert's calculations assumed that the amount of Epicus's monthly billings remained constant throughout FY 2004, when in fact they increased substantially over the year, and that Epicus sent bills to its customers throughout each month, when, according to Respondents' work papers, Epicus sent 80% of its bills to customers during the last three days of the month. If the expert had taken these factors into account, his calculations would have been even more complex, and would have led to a different, higher misstatement amount. Both the expert and Hatfield stated that they could not estimate what that amount would be.

Analysis

AU § 150.02 and AU § 230 of the Board's interim auditing standards required Respondents to exercise due care in the performance of the Epicus audit. Respondents were required "to plan and perform the audit to obtain reasonable assurance about whether the financial statements [were] free of material misstatement, whether caused by error or fraud."[1] Respondents knew that Epicus's FY 2004 financial statements contained a misstatement attributable to its non-GAAP revenue recognition policy. They were required, therefore, to obtain reasonable assurance that that misstatement did not cause the financial statements to be materially misstated.

Before the Board, Respondents argue, as they testified at the hearing, that they evaluated materiality by performing a "mental check and sight analysis." While they concede that the misstatement resulting from the non-GAAP accounting exceeded the "quantitative materiality threshold," they argue that "qualitatively the GAAP departure was not material." The hearing officer noted that Hatfield appeared uncertain and unconvinced of his own claim that he conducted a materiality evaluation and concluded that his demeanor strongly suggested that his testimony in that regard was fabricated.

Respondents have provided no basis for the Board to revisit the issue of Mr. Hatfield's demeanor at the hearing. In addition, the record provides ample reason not to credit Hatfield's testimony on this point. Prior to the hearing, Hatfield never claimed to have conducted a mental check and sight analysis, even though he had ample opportunity and motive to do so. In fact, during the investigation of this matter he testified that he could not recall having conducted any materiality analysis; that, if he had done so, he would have expected to find it reflected in the work papers; and that the absence of a work paper indicated that "there was nothing available for me to do." And when Respondents replied to the Division's notice that it intended to recommend that the Board issue an OIP alleging, among other things, that Respondents had failed to conduct a materiality evaluation, Respondents did not claim that Hatfield had conducted a materiality evaluation. Instead, they asserted that Epicus's management could not provide the information required to do so. Finally, Hatfield has never—not at the hearing and not in his briefs before the Board—offered any credible description of the "visual and mental check" or explained in any coherent manner how he concluded that Epicus's GAAP departure was not material.

We conclude that, even if Hatfield performed a "mental check and sight analysis" of whether Epicus's GAAP departure caused its financial statements to be materially misstated it was not sufficient to comply with our standards. Respondents' own expert admitted that the hypothetical work paper he created to demonstrate the kind of evaluation Hatfield claimed to have performed resulted in an amount that exceeded Respondents' materiality and tolerable misstatement amounts. Had Respondents truly performed any sort of meaningful materiality analysis, and had that analysis returned a result in excess of the materiality and tolerable misstatement amounts that Respondents had set in planning, Respondents could not simply have "considered the

[1] AU § 110.02.

context of Epicus [sic] financial condition and performance," decided that the misstatement was not qualitatively material, and continued on with the audit.[2/]

2. Confirmation of FY 2004 Accounts Receivable

Facts

In its FY 2004 financial statements, Epicus reported year-end accounts receivable totaling approximately $5.7 million, net of an allowance for doubtful accounts of $1.5 million. This represented approximately 75% of Epicus's reported year-end assets. Epicus classified its accounts receivable as relating either to amounts due from residential or commercial customers for telephone service, or to carrier access fees due from the telecommunications companies whose services Epicus resold. Residential and commercial customers were further subdivided into active and inactive accounts. All service to inactive accounts had been terminated and Epicus assigned the receivables due from those accounts for collection, either by Epicus's in-house staff or outside collection agencies.

Epicus's receivables included approximately $3.1 million due from active accounts; $1.5 million due in carrier access fees; and $2.6 million due from inactive accounts, approximately $1 million of which had been assigned to outside agencies for collection. Respondents did not send confirmation requests to any of Epicus's active customers to confirm the existence of active accounts receivable, to any telecommunications companies to confirm carrier access fee receivables, or for any inactive accounts.

Analysis

AU § 330.34 of the Board's interim auditing standards provides that "[c]onfirmation of accounts receivable is a generally accepted auditing procedure," and that because "it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity . . . there is a presumption that the auditor will request the confirmation of accounts receivable during an audit . . . ." Respondents' work papers indicate that they decided not to send positive confirmations because there were a "[l]arge number of small accounts with little possibility of accurate response," and because "[t]he use of positive audit confirmations is not practical due to the existence of approximately 40,000 separate accounts with no single account or group of accounts being significant within the population. Accordingly the confirmation response rate would not be cost effective."

[2/] Aside from their arguments that "there was no impact on earnings per share" and that Epicus had reported losses and negative cash burn, Respondents have offered no explanation of how they determined that the misstatement was not qualitatively material.

In addition, Hatfield testified that one of his reasons for not sending confirmation requests was "so that time can be saved by opting out of the positive confirmation process."

Respondents argue that in the Epicus audit they made an allowable determination not to send confirmation requests under AU § 330.34, which provides that an auditor might elect not to send confirmation requests if the auditor determined that "[t]he use of confirmations would be ineffective." Under AU § 330.23:

> In determining the effectiveness and efficiency of employing confirmation procedures, the auditor may consider information from prior years' audits or audits of similar entities. This information includes response rates, knowledge of misstatements identified during prior years' audits, and any knowledge of inaccurate information on returned confirmations. For example, if the auditor has experienced poor response rates to properly designed confirmation requests in prior audits, the auditor may instead consider obtaining audit evidence from other sources.

Respondents had no relevant information from prior Epicus audits as to the utility of confirmations because they had never sent confirmation requests to Epicus's customers in their prior audits. Respondents' work papers do not cite any audits of similar entities to support their conclusion that sending confirmation requests to Epicus's customers would be ineffective,[3/] but, at the hearing, Hatfield testified that he relied on his prior experience while participating in fifteen audits during the 1970s and 1980s. Respondents argue that those audits provide support for Respondents' conclusion that sending confirmation requests to Epicus's customers would be ineffective.

Whatever the merits of Respondents' "too many small accounts" justification as it relates to the active accounts,, it clearly had no application to the carrier access fee receivables, as Respondents' own expert admitted at the hearing. Epicus's accounts receivable included approximately $1.5 million for carrier access fees, most of which were claimed due from just four of the 20 companies. Yet Respondents did not send confirmation requests to any of the companies to confirm the existence of these receivables. Respondents' failure to send confirmations to these companies was particularly significant because, during FY 2005, Epicus's management discovered that a former executive had directed employees to make false entries in Epicus's computerized customer accounts records, which, they concluded, led to an overstatement of Epicus's carrier access fee receivables. If Respondents had sent requests to confirm the carrier access fee receivables in their audit, they might have

[3/] AU § 330.35 directed that "[a]n auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame th[e] presumption [in favor of sending confirmations]."

discovered the overstated carrier access fee receivables, which would have alerted Epicus's management to the possible fraud and overstatement at an earlier date.

Respondents argue that "carrier access fee receivables were a creation of federal statute," and that "this validates and confirms the existence of the receivable." This is simply incorrect. Indeed, even Respondents' own work papers indicated only that they believed the "collectability" of the carrier access fee receivables, not their existence, was "relatively assured by statute as long as the carrier in question remains solvent and operating." Similarly, at the hearing, Hatfield contended that the telecommunications companies' statutory obligation to pay carrier access fees supported the collectability of the receivables, not their existence.[4/]

Respondents are similarly unable to explain their failure to confirm approximately $1 million dollars in inactive accounts receivables assigned to collection agencies. At the hearing, Hatfield claimed he did not attempt to confirm inactive account receivables because "we accounted for those in the allowance for bad debt calculation." An allowance calculation, however, is not a substitute for confirmation of the existence of the receivable. Moreover, in calculating an allowance for Epicus, Respondents assumed that Epicus would collect 40% of the inactive account receivables it had assigned for collection, even though Respondents had done nothing to confirm the existence of those receivables.

Respondents argue that "the placement of an existing receivable with a collection agency and the confirmation of that event does provide reliability as to the continuing existence and collectability, if limited and recognized by the offsetting allowance of the receivable." Respondents, however, never confirmed that the $1 million in inactive account receivables were, in fact, "existing receivables." And whatever the placement of an "existing receivable" may say about that receivable's "continuing existence," mere placement of a receivable with a collection agency provides no reliability about the receivable's existence in the first instance.[5/]

[4/] Respondents also argue that the fact that they were unable to obtain information from Bell South about the existence of certain carrier access fees demonstrates that attempting to confirm carrier access fee receivables would have been ineffective. But this occurred after the FY 2004 audit, and therefore is not relevant to the sufficiency of that audit.

[5/] AU § 330 includes no exception to the confirmation requirement for receivables assigned for collection, nor would there be any logical reason to assume the existence of a receivable merely because the company's records indicated that it had been assigned to a collection agency.

3. Alternative Procedures to Test FY 2004 Accounts Receivable

Facts

Though they did not send any confirmation requests, Respondents contend that they employed adequate alternative procedures to test the existence of Epicus's accounts receivable by reviewing Epicus's cash receipts during a 53-day period following the close of FY 2004. In conducting that review, Respondents did not attempt to match Epicus's receipts with the actual items being paid. Instead, they accepted certain representations from Epicus concerning the firm's historic experience regarding the timing of receivable payments, without testing the validity of those representations. Respondents used those untested representations to determine, "looking at the broad picture," how much of the cash that Epicus received during the 53-day period related to Epicus's year-end accounts receivable balances.

Using this methodology, Respondents concluded that a total of approximately $2.3 million in cash received during the period related to payments on active year-end residential and commercial receivables, which totaled $3.1 million. Respondents did nothing to test the existence of the remaining $800,000, even though that amount substantially exceeded their planning materiality and tolerable misstatement thresholds for the audit. Similarly, Respondents concluded that approximately $0.7 million in cash collected during the period was attributable to payments on carrier access receivables, which totaled $1.5 million, but did nothing to verify the existence of the remaining $0.8 million, even though, again, that amount substantially exceeded Respondents' planning materiality and tolerable misstatement thresholds. Finally, Respondents did not attribute any of Epicus's cash receipts during the period to the approximately $2.6 million in receivables for inactive accounts reflected in Epicus's FY 2004 financial statements, including both those retained for in-house collection and those referred to outside collection agencies, yet they did not employ any alternative procedures to test the existence of those receivables.

Analysis

AU § 330 of the Board's interim auditing standards requires auditors to use alternative procedures to test the existence of accounts receivable that were not confirmed through a confirmation process. Under those standards, "alternative procedures may include examination of subsequent cash receipts (including matching such receipts with the actual items being paid) . . . ."[6/] Regardless of the specific procedures employed, however, PCAOB interim auditing standards required

[6/] AU § 330.32.

Respondents to use due professional care, obtain sufficient competent evidential matter, and exercise professional skepticism in all aspects of their audit.[7]

Respondents argue that they tested the accounts receivable for both existence and validity. Respondents explain that "inactive" accounts were not tested because they were being pursued by internal and external collections, and thus, they contend, their existence could be assumed. Respondents maintain that "confirmation of the amounts in collection for inactive accounts was taken into account in the allowance for bad debt calculation." Respondents argue that they "use[d] a subsequent cash collection method to verify the existence and amount of active accounts receivable," and that "Respondents [sic] testing of accounts receivable for the balances due on active and inactive receivables demonstrated that management's reports were reliable."

With respect to active account receivables and carrier access fees, Respondents' examination of subsequent cash receipts did not meet the requirements of PCAOB standards. Respondents did not attempt to match cash receipts with the accounts being paid. Rather, Respondents simply considered Epicus's total claimed receivables and the total cash received, and applied untested assumptions provided by the company. Even so, Respondents were only able to confirm the existence of a portion of the claimed receivables, but did nothing at all to test the existence of the balance. And Respondents performed no alternative procedures whatsoever to test the existence of the claimed receivables for inactive accounts. As noted above, placement of a receivable with a collection agency tells the auditor nothing about whether that receivable exists.

4. Value of FY 2004 Accounts Receivable

Facts

As discussed above, Epicus carried its accounts receivable on its FY 2004 financial statements net of a $1.5 million allowance for doubtful accounts. Hatfield acknowledged that as part of Respondents' audit procedures they were required to test this allowance, and he purported to do that in Respondents' work papers.

Hatfield testified that, in performing his test, he did not use the company's methodology for calculating the allowance. In fact, during his investigative testimony, he stated: "The company's protocols for analysis on the accounts receivable was a flat per month charged to bad debt expense . . . based on a number that was pulled out of the air."

Therefore, Hatfield performed his own calculations to determine the allowance that should be reflected in Epicus's financial statements. In his calculations, he

[7] AU §§ 150, 230, 326.

considered only Epicus's receivables for active and inactive accounts. He assumed that no allowance was needed for carrier access fee receivables, because the telecommunications companies had a legal obligation to pay the fees, even though he had not tested the existence of those receivables.

In calculating an appropriate allowance for active account receivables, Respondents accepted, without requiring any supporting evidence, Epicus's representation that 90% of its active accounts receivable were paid within 90 days. Respondents' work papers indicate that, based on this representation, they intended to take "an arbitrary 10% of the active [accounts receivable] . . . for estimated uncollectible accounts," or approximately $310,000. Instead of employing this methodology, Hatfield used Epicus's receivables aging report to estimate that the company had approximately $1.1 million in past due active accounts receivable, even though Respondents' work papers state that "[t]he Company has no workable aging reports." Hatfield then calculated an allowance of 10% of that figure, or approximately $110,000. Hatfield admitted that this approach was not in accordance with the work papers, and that the allowance for active account receivables "should have been 10 percent of three million one instead of one million one . . . ."

In calculating an allowance for Epicus's inactive account receivables, Hatfield assumed that Epicus would collect 50% of the receivables assigned for in-house collection and 40% of the receivables assigned to outside collection agencies. He based those assumptions on his own experience in various contexts over the years, not on any information provided by Epicus concerning its historical experience in collecting accounts receivable, and he did not test the validity of his assumptions in terms of Epicus's actual experience. For in-house collections, the 50% assumption was simply what Hatfield "anticipated the best case scenario for collections on that bracket of receivables would be"; he admitted that the "[w]orst case [scenario] would be zero." For outside agency collections, his assumption was based on his view that "[o]utside collection agencies have a relatively weak history . . . ."

Analysis

PCAOB standards required Respondents to exercise due professional care in performing audit procedures to test Epicus's allowance for doubtful accounts.[8/] Respondents argue that the method that they used to do so, which, they claim, included conducting a risk assessment and interviewing appropriate company personnel, was sufficient.[9/] Respondents note that there is no evidence in the record that the allowance

[8/] AU § 230.

[9/] Respondents' briefs before the Board also assert that they "tested management's representations and found such to be reasonable." But that assertion is for doubtful accounts was misstated or that the financial statements were not fairly presented in this regard.

Respondents' arguments do not address the facts that, in calculating an allowance for Epicus's active accounts, they failed to follow their own methodology, and, as a result arrived at an allowance that was only about one-third the amount that their own methodology should have yielded. The difference, approximately $200,000, was more than the tolerable misstatement amount that Respondents had established for the audit. Whether or not the allowance or the financial statements were ultimately found to be misstated is not relevant to the adequacy of the procedures performed during the audit. With regard to the allowance for active accounts receivable, Respondents failed to exercise due professional care.

Moreover, with regard to inactive receivables, Respondents obtained no competent evidential matter whatsoever. Respondents assumed the collection of a portion of receivables, the existence of which they had not verified, and used assumptions based on Hatfield's unrelated prior experience, without making any effort to determine whether those assumptions had any application to Epicus's actual historical experience. Accordingly, Respondents also failed to comply with the Board's requirement to obtain sufficient competent evidential matter to afford a reasonable basis for the opinion.[10/]

5. FY 2005 Revenue Recognition

Facts

In October 2004, during Epicus's FY 2005, Epicus filed for Chapter 11 bankruptcy. The company remained in operation, and its 2005 financial statements, as audited by Respondents, reported total revenue of $18,775,796. Epicus changed its revenue recognition policy in calculating its revenue for its FY 2005 financial statements, and included a description of its policy in its Form 10-KSB for FY 2005 filed with the SEC:

> Revenue for services billed in advance is recognized on a pro rata basis over the course of the related billing cycle and revenue for long distance service billed in arrears is recognized at the respective billing date. Accordingly, the Company has recognized an unearned revenue item in the accompanying balance sheet for unearned advance billings for service.

unsupported in the brief, and we can find no evidence in the record that would support it. Accordingly, we give it no weight here.

[10/] AU § 326.

This disclosure was incomplete, because it did not disclose that Epicus had changed its policy, and it was incorrect, in part, because the Form 10-KSB included Epicus's FY 2004 financial statements, as to which, as discussed above, Epicus employed a different revenue recognition policy that was not in accordance with generally accepted accounting principles. In addition, the nature and effect of the change in policy was not disclosed.

Analysis

At the time of Respondents' audit of Epicus's FY 2005 financial statements, AU § 420 of the PCAOB's interim auditing standards provided that an audit report should identify those circumstances in which accounting principles were not applied consistently in the current period in relation to the preceding period. It explained:

> The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (a) no change in accounting principles has occurred, or (b) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor would not refer to consistency in his report.

Because Epicus used a revenue recognition policy that was not in accordance with generally accepted accounting principles in FY 2004, any change to that policy should have been accounted for as a correction of an error by restating one or more prior periods, if the effect was material. Moreover, because Epicus did not apply the same revenue recognition policy in FY 2005 that it had used in FY 2004, AU § 420 required Respondents to evaluate whether the change had a material effect on the comparability of Epicus's FY 2004 and FY 2005 financial statements.

There is no indication in Respondents' work papers that they conducted such an evaluation, and in his investigative testimony Hatfield acknowledged that he was not sure he had even considered that issue. Nevertheless, Respondents did not address in their audit report Epicus's inconsistent revenue recognition polices as reflected in the FY 2004 and FY 2005 financial statements covered by the audit report.

Before the Board, Respondents argue, for the first time, that they were not required to apply AU § 420. Respondents' argument appears to be that as of the date of their FY 2005 audit report, Epicus management planned to adopt fresh start accounting pursuant to AICPA Statement of Position 90-7 ("SOP 90-7"). SOP 90-7 states that "fresh start financial statements prepared by entities emerging from bankruptcy will not be comparable with those prepared before their plans were confirmed because they are, in fact, those of a new entity." Respondents argue that "'[f]resh start financial statements do not need to compare change in accounting policy or the material effect thereof."

By its terms, however, SOP 90-7 does not allow fresh start accounting to begin until the entity's reorganization plan is confirmed by the bankruptcy court. Respondents' brief notes that this did not happen until December 8, 2005, which was after the date of their audit report on Epicus's FY 2005 financial statements.[11/] While Respondents concede that December 8, 2005 was the date Epicus adopted fresh start accounting "for accounting purposes," they appear to argue that AU § 560, which governs the auditor's response to subsequent events, relieved them of their obligation to consider the comparability of Epicus's FY 2004 and 2005 financial statements. Their argument appears to be that because Epicus management expected fresh start accounting to commence sometime after the FY 2005 audit report was issued, they changed the accounting policy early because AU § 560.03 says that "[a]ll information that becomes available prior to the issuance of the financial statements should be used by management in its evaluations of the conditions on which the estimates were based."

Respondents' argument is baseless. Whatever the merits of their claim that because fresh start financial statements are those of a new entity the auditor need not apply AU § 420 in auditing them, that argument fails here as a factual matter. Epicus did not adopt—and could not, consistent with SOP 90-7, have adopted—fresh start accounting until after Respondents issued their FY 2005 audit report. Therefore, Epicus was not a "new entity," as SOP 90-7 uses that term, at any point in FY 2005. Epicus was the same entity as it was in FY 2004. Accordingly, nothing in AU § 560 excused Respondents from their obligation to comply with AU § 420.

6. FY 2005 Accounts Receivable

Facts

In its FY 2005 financial statements, Epicus reported year-end accounts receivable of $1,415,849, net of a $500,000 allowance for doubtful accounts. The financial statements include a disclosure stating that, after it filed for bankruptcy under Chapter 11, Epicus:

[11/] On May 5, 2010, the Division moved to adduce additional evidence consisting of the Form 10-KSB filed by Epicus for the fiscal year ended May 31, 2006. In its motion, the Division notes that the evidence was not relevant to the hearing because Respondents did not claim that their audit of Epicus's FY 2005 financial statements was affected by Epicus's adoption of fresh start accounting. Respondents make that claim for the first time on appeal. The Form 10-KSB offered by the Division provides evidence of what Respondents concede in their brief; specifically, it shows that Epicus did not adopt fresh start accounting until after it filed its FY 2005 financial statements. Accordingly, we grant the Division's motion.

> adopted the policy of recording a net accounts receivable balance equal to the actual cash collected during the 30 day period subsequent to any reporting period. Any differential between the Company's actual accounts receivable and the actual subsequent cash collections is recorded as bad debt expense in the reporting period.

In effect, therefore, Epicus determined that it would retroactively write off, as uncollectible, any receivable amounts not collected within 30 days after year-end. In conducting their audit, Respondents accepted this approach; Hatfield testified that "this was one of the most conservative presentations that [Epicus] could develop." According to Respondents' work papers: "The actual AR balance is much higher [than the amount collected during the 30 day period]; however, the client has no monitoring or collection protocol in place to allow any collectability reliability on delinquent AR accounts."

Respondents' work papers indicate that Epicus's actual year-end accounts receivable totaled approximately $2.6 million. Respondents determined that Epicus received $1,384,849 in cash during the 30 day period following the end of FY 2005. As in FY 2004, Respondents did not attempt to determine whether any of that cash related to any specific receivable, and thus could not verify that the cash related to FY 2005 revenue. And once again, Respondents did not send confirmation requests to establish the existence of any receivable.

In testing the amount of receivables that should be reflected in Epicus's financial statements under its declared policy, Respondents, for reasons that are not clear, "grossed up" the actual cash collections by $500,000, but offset that amount with a $500,000 allowance for doubtful accounts, and they also added $31,000, which Respondents determined was the average amount of carrier access fees collected by Epicus during the three month period prior to year-end FY 2005. This calculation supported the receivables ($1,415,849, net of a $500,000 allowance for doubtful accounts) reflected in Epicus's financial statements. Respondents also determined that Epicus should increase its bad debt expense for FY 2005 by $711,664, in accordance with its stated policy to record the difference between the actual accounts receivable and the cash collected during the 30 day period as bad debt, and Epicus's financial statements reflect that the company accepted Respondents' proposed adjustment.

Analysis

Under PCAOB interim auditing standards, Respondents were required to obtain sufficient competent evidential matter to afford a reasonable basis for their opinion and to exercise professional skepticism, including "a questioning mind and a critical assessment of the audit evidence," in their audit.[12/] With regard to Epicus's 2005

[12/] AU §§ 230.07, 326.01.

accounts receivable, Respondents did nothing to test whether management's assumption that it would not collect receivables after 30 days was reasonable. This was so even though it was contrary to the representation Respondents had accepted, without testing, for their FY 2004 audit that Epicus received payment of a substantial portion of its receivables more than 30 days after year end. They also did nothing to trace any of the cash Epicus did receive during that 30 day period to any specific receivables, or to confirm the existence of any receivable.

Respondents contend that Epicus's methodology was reasonable under the circumstances of the bankruptcy proceeding and "the lack of personnel to monitor and pursue collection." Respondents argue that "[t]here was no evidence reviewed by the auditor to reasonably predict that there would be any collectability reliability beyond 30 days" and that tracing cash to receivables was unnecessary because "management recognized and accounted for potential bad debts at the point of billing, by recognition of bad debt of all the account receivable balance less the known cash collections in the following month." According to Respondents, "[t]he audit test to determine whether cash received in the 30 days following year end provided a reasonably accurate estimate of the year end accounts receivable balance is taken into account by the entries of 'debit-bad debt expense' and 'credits to accounts receivable.'"

The fact that Respondents did not review any evidence suggesting that management was incorrect when it assumed that it would not collect receivable amounts after 30 days is not a substitute for evidence that the assumption was reasonable, particularly in the face of management's representations to the contrary the previous year. Respondents also do not explain how Epicus's accounting for bad debt, as described in Respondents' briefs, provided them with evidence of the receivables' existence. Because Respondents did not perform sufficient procedures to test management's representations with regard to the accounts receivable and instead merely accepted management's representations, they failed to comply with PCAOB auditing standards.

B. The Bidville Audit

Bidville, a Nevada corporation based in Florida, was established through a reverse merger with a publicly traded company in December 2003. Bidville's stock was quoted on the OTC Bulletin Board, and, at all relevant times, Bidville was an issuer, as defined in the Act and the PCAOB's rules. Bidville's expressed business plan was to operate an internet online auction site as a competitor to eBay.

Respondents became Bidville's auditor in connection with its FY 2003 audit, and issued an unqualified audit opinion on Bidville's 2003 financial statements.[13/] The financial statements, together with Respondents' opinion, were filed with the SEC in Bidville's annual Form 10-KSB for FY 2003.

Respondent Hatfield testified in his investigative testimony that at the time Respondents became Bidville's auditor, his assessment was that Bidville was "an eBay wannabe" and had been created as a "great stock spoof," a "stock game . . . a market play." He believed it was a "stock scam" and that the company's management "had no intent to run [a] company."[14/]

1. Private Placement Agreement

Facts

In December 2003, Bidville concluded a private placement through which it sold 4,410,000 shares of Bidville stock at $.50 per share, "each Share with a ½ warrant. Each full such warrant convertible into one share of Bidville common stock at $1.00 per share . . . ." The private placement stock was unregistered and restricted, and the warrants were also unregistered.

Respondents had no knowledge that this was other than an arm's length transaction. Respondents were not aware of the purchasers providing any services to Bidville in connection with the transaction or of any relationship between the purchasers and Bidville—they did not consider the issue relevant. Nevertheless, during their audit, Respondents proposed an adjustment to Bidville's financial statements in an amount equal to the difference between the "fair value" of the stock issued in the private placement and the actual proceeds of the private placement as "compensation expense related to common stock issuance at less than 'fair value,'" and Bidville made the adjustment.

Respondents calculated the fair value of the unregistered, restricted stock sold in the private placement by applying a 50% "haircut" to the reported closing price for Bidville's registered, freely tradable stock on the day the private placement closed.

[13/] In connection with the reverse merger, Bidville changed its fiscal year-end from February 28 to December 31. As a result, the period covered by Respondents' audit was March 1, 2003 through December 31, 2003.

[14/] In his testimony during the investigation, Hatfield contended that subsequent events had substantiated his fraud concerns, but at the hearing he insisted that he had "no evidence that it actually came to pass." The issues in this case concern whether Respondents complied with PCAOB audit standards, not whether there was actually any fraudulent intent or action on the part of Bidville's management.

Based on this fair value, Respondents concluded that Bidville had realized approximately $10 million less for the stock sold in the private placement than its fair value. In arriving at that amount, Respondents did not ascribe any value to the warrants that were included in the private placement. The adjustment that Respondents recommended and Bidville accepted accounted for $10,051,800 of the $10,296,897 in comprehensive loss reported by Bidville in its financial statements.

Respondents were not aware of any GAAP that required or supported either the need for a compensation expense adjustment or the 50% discount that they used in calculating fair value for purposes of the adjustment. Instead of relying on GAAP, Hatfield testified that, based on auditing similar transactions over a number of years, he relied on his understanding of industry practice and SEC staff approval to support both the need for an adjustment and the use of a 50% discount from market price to establish fair value.

More specifically, Hatfield testified: "The initial guidance came from a client who had significant securities experience, and then the position was later supported by the SEC through not issuing any comments on point during reviews of registration statements coming forward." In response to a question from his counsel, he confirmed that it was "the absence of any negative comment [from the SEC] on the treatment on the financial statements" he audited, rather than affirmative approvals from SEC staff, that he relied on. He based the Bidville adjustment on this experience; he did not consult the SEC staff about the Bidville transaction, specifically. Hatfield explained his understanding of the reason for calculating the fair value of the private placement stock based on a 50% discount from the market price for Bidville stock:

> The theory behind [the 50% discount] originally was that in issuing restricted shares that had to be held for a defined period of time . . . there was always room for the market to shift and adjust to the detriment of the holder before they would be able to sell those shares in the open market. The unwritten industry accepted position from the very first time I became involved with this on a 1999 audit engagement was that the acceptable discount was 50 percent.

Respondents' expert, on the other hand, offered a different explanation, suggesting that the 50% "haircut" applied by Respondents in establishing the fair value of the private placement reflected a "blockage discount."

Analysis

PCAOB interim auditing standards required Respondents to exercise due professional care and professional skepticism in their audit, and to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements. In particular, among other things, in order to exercise due care: "The auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards . . . ."[15] Yet Respondents proposed a $10 million adjustment, which the company accepted, without being aware of any GAAP that supported either the need for the adjustment or the manner in which they calculated it.

Respondents contend that Section 7520.2 of the SEC's Division of Corporation Finance's Financial Reporting Manual provides support for their approach to the adjustment, and that "[a]t the time the Bidville transaction occurred, the 50% adjustment to closing market price was then the industry (albeit unwritten) position, which was not unreasonable or inappropriate to the SEC staff or even to the FASB." Respondents also argue that the concurring reviewer "corroborated similar interaction with the SEC on accounting for the issuance of cheap stock" and that "Respondents also testified to prior experiences with the SEC on this issue."

Nothing in the cited provisions of the SEC staff manual suggests that issuers should apply a standard discount of 50% to shares sold under the circumstances of this case. Similarly, nothing in the testimony to which Respondents refer supports such an approach. Respondents do not suggest that the SEC staff considered the treatment of the Bidville shares and approved of it, but only that the SEC staff had not commented on similar accounting by other issuers. The lack of SEC staff comment on another company's accounting does not suggest, however, that the SEC approved of that other company's accounting, let alone that it was appropriate for Bidville.

Respondents had no reasonable basis for believing that their proposed adjustment to the Bidville financial statements was necessary or appropriate under GAAP, and thus had no reasonable basis for expressing an opinion that the financial statements, which included that adjustment, were fairly stated, in all material respects, in conformity with GAAP. Moreover, even assuming that a compensation expense adjustment was appropriate, and that for purposes of the adjustment it was necessary to determine the fair value of the private placement, Respondents failed to comply with PCAOB auditing standards in making that determination. Those standards required Respondents to obtain sufficient, competent evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP.[16] Instead, Respondents used a 50% discount from the closing market price for Bidville's registered, freely tradable stock as the fair value for the stock in the private placement without obtaining any evidence that this provided a reasonable measure of the actual fair value of the private placement and without being aware of any GAAP supporting that valuation.

[15] AU § 230.06.

[16] AU § 328.03.

2. Consulting Agreement

Facts

In December 2003, Bidville and the Royal Palm Capital Group, Inc. ("Royal Palm"), a company controlled by the same individuals who controlled Bidville, entered into a consulting agreement with National Securities Corporation ("National Securities"), which had conducted the private placement on behalf of Bidville. The agreement provided that National Securities was to provide financial, investment banking, and merger/acquisition services to Bidville, in exchange for which Royal Palm would transfer to National Securities, "upon execution of this Agreement," approximately four million shares of Bidville stock owned by Royal Palm, for a purchase price of $500.

Respondents were unaware of the consulting agreement when they completed their audit of Bidville's 2003 financial statements and issued their opinion, and the OIP does not allege that they should have been aware of it at that time. Respondents requested copies of all consulting agreements involving Bidville during their audit, and were provided with several such agreements, but Hatfield testified that the one between Bidville, Royal Palm, and National Securities "was withheld from me." Respondents first learned of that consulting agreement on April 22, 2004.

On April 22, after the agreement came to light, Bidville management notified Respondents that it intended to file an amended Form 10-KSB, and that the amendments would "impact the financial statement disclosures." On April 29, 2004, after Bidville management provided an initial draft of the amended form to Respondents for their review, Hatfield advised Bidville's president that he believed Bidville had "no one that knows how to characterize and disclose the myriad of deals and contracts being entered into." On May 3, 2004, Hatfield notified Bidville's president that, because of "this behavior pattern and lack of internal control," Respondents were evaluating whether they would continue to serve as Bidville's auditor.

On May 7, 2004, Bidville filed its amended Form 10-KSB with the SEC that disclosed the consulting agreement, but made no adjustments to Bidville's previously filed financial statements. The amended form included an unqualified opinion from Respondents that Bidville's previously filed financial statements were fairly presented in conformity with GAAP, in all material respects, and that the consulting agreement "had no effect on the Company's financial statements."

Hatfield reached that conclusion because he concurred in "an interpretation of management . . . that the contract was not triggered until consideration was provided on both sides of the contract." Hatfield received a Bidville shareholder list that did not include National Securities, but he did not contact National Securities or take any other steps to determine whether management's interpretation of the contract was correct.

Respondents later concluded that management's interpretation was incorrect, and that Bidville should have recorded the impact of the agreement on its FY 2003 financial statements. In October 2004, Bidville filed another amended Form 10-KSB that included a restatement of its FY 2003 financial statements in which it recognized a charge of approximately $15.8 million attributable to the consulting agreement. The filing included Respondents' unqualified opinion that the restated financials were fairly presented, in all material respects, in conformity with GAAP.

On May 21, 2004, Respondents issued a review report in connection with Bidville's planned filing of a Form 10-QSB for the quarter ending March 31, 2004. In the review report, Respondents stated that they were "not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles." By May 24, however, prior to the filing of the Form 10-QSB, Respondents learned that the Royal Palm shares had been transferred to National Securities in February 2004, and Hatfield sent an email to the president of Bidville indicating his belief that the financial statements included in the Form 10-QSB should reflect "3,966,700 shares @ $3.00'ish, discounted by 50% less the $500 as a charge to the P&L for consulting fees and a credit to additional paid-in capital." Hatfield noted in the email, however, that "[t]o make this change would totally blow the timeline to file today," and that Bidville's chairman and CEO had "agreed to let the filing go and we'll book the effect of this off-balance sheet transaction in the next quarter." Respondents did not withdraw or modify their review report, and the Form 10-QSB was filed on May 25, 2004.

Although his email indicated that Bidville planned to book the transaction "in the next quarter," Hatfield testified that, in fact, Bidville's management had represented that it would file an amended Form 10-QSB with corrected financial statements within five days, and that Respondents agreed to the filing of the Form 10-QSB based on that representation. Bidville did not, however, file an amended form within five days. In June, Hatfield sent an email to Bidville's president indicating that "the 3/31/04 10-QSB should be amended as [the National Securities] transaction took place in 2/04 and was not recorded in the Bidville financial statements." In early July, he received a reply indicating that Bidville was "actively working" on an amended form.

By letter dated August 2, 2004, Respondents withdrew as Bidville's auditor, citing the circumstances surrounding the National Securities consulting agreement. In the letter, Respondents indicated their belief that the failure to account for the consulting agreement transaction in the company's financial statements, as filed in the Form 10-QSB, caused the statements "to not be 'materially correct' and not presented in accordance with generally accepted accounting principles."

After Respondents resigned, they were approached by Bidville and asked to assist with a restatement of the company's FY 2003 financial statements, and they accepted the assignment. As noted above, Bidville filed an amended Form 10-KSB with the SEC on October 1, 2004, which contained the restated financial statements, as well as Respondents' unqualified opinion.

Analysis

AU § 561.01 of the Board's interim auditing standards required that "the auditor who, subsequent to the date of the report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected the report had he or she then been aware of such facts" perform certain procedures to determine whether those facts would have affected the audit report. The procedures required depended on the particular facts and circumstances, but if the new information "is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report."[17/] If the auditor determines that the information is reliable, and the facts existed at the time of the report, the auditor may be required to advise the client to disclose the facts through the issuance of revised financial statements, together with a new audit report disclosing the reasons for the revisions, and if the client fails to make such disclosures, the auditor is required to take additional steps.[18/]

Respondents argue that they took appropriate steps upon learning of the consulting agreement. Specifically, they appear to contend that they did more than simply accept management's interpretation of the contract in determining that the contract had not yet been "triggered" because consideration had not been provided "on both sides of the contract." They claim that:

> The independent third party transfer agent report did not show the shares issued and/or transferred on the shareholder list. Audit programs direct an auditor to confirm stock issuances with the third party transfer agent. Respondents did this. Respondents also inquired of management and received a response consistent with the transfer agent record. (internal citation omitted.)

We can find no evidence in the record, however that Respondents, confirmed stock issuances with the third party transfer agent. Rather, Hatfield testified, he received a shareholder list from Bidville management, which did not show an issuance of stock to National Securities. Nor can we identify evidence that Respondents did anything else to evaluate whether the consulting agreement had a material effect on Bidville's financial statements, other than talking to Bidville management. Although Hatfield had expressed his belief that Bidville had no one who knew how to characterize and disclose a consulting agreement, and that Bidville's management was planning, or

[17/] AU § 561.04.

[18/] AU §§ 561.05-561.09.

engaged in, a "stock spoof" or a "stock scam," Respondents failed to undertake any reasonable investigation to determine whether the agreement had a material effect on Bidville's financial statements. Instead, they accepted Bidville management's interpretation of the agreement without testing it. As a result, Respondents lacked a reasonable basis for expressing the opinion, included in the amended Form 10-KSB filed on May 7, 2004, that the agreement had no effect on Bidville's financial statements.

Respondents also failed to comply with PCAOB interim auditing standards requiring them to exercise due care and professional skepticism in connection with their review of the Form 10-QSB that Bidville filed on May 25, 2004. On May 21, Respondents issued a review report indicating that they were unaware of any material modifications required to make the financial statements conform to GAAP. But before Bidville filed the Form 10-QSB, Respondents had determined, and advised Bidville, that the consulting agreement required an adjustment to Bidville's financial statements for the quarter of approximately $6 million.

In their resignation letter, Respondents stated that Bidville's failure to make this adjustment had caused its financial statements to be materially misstated, yet they nevertheless allowed Bidville's management to file the Form 10-QSB, without objection. During his investigative testimony, Hatfield stated that in allowing the filing without objection, he "rolled over." Worse yet, he did so even though, he testified, he believed that Bidville management "want[ed] to get filings into the marketplace as quick as possible so that they can do smoke-and-mirror fluffing press releases to pump the stock . . . . This company is a premier example of an entity that could be subject to a pump and dump."

At the hearing, Hatfield testified that in allowing Bidville's management to file the Form 10-QSB without objection he relied on management's representation that the company would file an amended form, correcting the financial statements, within five days. The hearing officer found that this testimony lacked credibility. On appeal, Respondents argue that Gary Alexander, who was employed by Bidville, also testified that management represented that it would file a revised Form 10-QSB within five days. According to Respondents, after they "tested all the information provided by management, Respondents determined, as was acceptable practice at the time, [Bidville] would restate and quantify the material impact of this undisclosed transaction by the quarter filing following the discovery of the undisclosed transaction."

It is unnecessary to determine whether, in fact, Bidville management represented that it would amend its filing. The relevant fact is that Respondents knowingly allowed Bidville to include in its filing a review report that falsely claimed that Respondents were unaware of any material modifications required to make the financial statements conform to GAAP. Permitting a client to include in its filing a review report that makes false claims was not "acceptable practice" at the time of the Bidville audit, nor is it now. Indeed, Respondent's own expert testified that if an auditor thought the client was engaged in a fraud, "you either insist that [the client] issue a Form 8-K or you communicate with the Commission or you withdraw," and he conceded that Respondents "did not do any of those things." While the expert nevertheless expressed the opinion that Respondents actions were reasonable, the facts do not support that view.

C. Summary of Violations

For the reasons set forth above, we conclude that, in connection with their FY 2004 audit of Epicus, Respondents violated PCAOB Rules 3100 and 3200T by:

- failing to perform procedures to evaluate whether Epicus's departure from GAAP in recognizing revenue caused Epicus's financial statements to be materially misstated, which failure violated PCAOB auditing standards, including AU §§ 150 and 230;

- failing to request confirmation of Epicus's accounts receivable, without having an adequate basis for making a determination that sending requests for confirmation of accounts receivable would be ineffective, which violated PCAOB auditing standards, including AU §§ 150, 230, 326 and 330;

- failing to perform adequate alternative procedures to test the existence of accounts receivable, which violated PCAOB auditing standards, including AU §§ 150, 230, 326 and 330; and

- failing to perform sufficient audit procedures to evaluate the collectability of accounts receivable and to conclude that Epicus's allowance for doubtful accounts was reasonable, which violated PCAOB auditing standards, including AU §§ 150, 230 and 326.

Further, in connection with their FY 2005 audit of Epicus, Respondents violated PCAOB Rules 3100 and 3200T by:

- failing to consider adequately the implications of a change in revenue recognition by Epicus, failing to address adequately Epicus's failure to disclose the change in its financial statements, and failing to consider whether accounting principles were consistently applied between periods, which violated PCAOB auditing standards, including AU §§ 150, 230, and 420; and

- failing to perform sufficient procedures to evaluate the reasonableness of Epicus's estimate of the 2005 year-end accounts receivable balance, which violated PCAOB auditing standards, including AU §§ 150, 230 and 326.

Finally, in connection with their FY 2003 audit of Bidville, Respondents violated PCAOB Rules 3100 and 3200T by:

- failing to perform sufficient procedures to determine whether Bidville had correctly valued and presented the results of a private placement in its financial statements, which violated PCAOB auditing standards, including AU §§ 150, 230 and 326; and

- failing to properly respond after they became aware, in April 2004, of a December 2003 consulting agreement that had not been disclosed or accounted for in Bidville's 2003 financial statements, which violated PCAOB auditing standards, including AU §§ 150, 230, 326 and 561.

III.

Section 105(c)(4) of the Act gives the Board authority to impose sanctions on registered firms or associated persons for violations of PCAOB rules and audit standards. In appropriate circumstances, sanctions may include revoking a firm's registration, barring an associated person, or imposing a civil money penalty. Section 105(c)(5), however, provides that the Board may impose a revocation or bar only for "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or . . . repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."[19/] PCAOB Rule 5300 provides that "the Board may impose such disciplinary or remedial sanctions as it determines appropriate, subject to the applicable limitations under Section 105(c)(5) of the Act . . . ." In determining the appropriate sanctions in this case, therefore, the first question that must be addressed is whether Respondents' violations rise to the level of conduct specified in Section 105(c)(5).

Respondents argue that their conduct cannot be reckless, because, at most, Respondents' conduct merely represented "a departure from ordinary care." Respondents contend that "[t]he issues here all concern auditor judgment and/or sufficiency of work papers, not audit failure," that "[t]he Hearing Officer's findings, disagreeing with a seasoned auditor's judgment, is a case of 20/20 hindsight," that "[a] difference in opinion regarding an auditor's judgment turns on what appears to have been reasonable at the time," and that "[r]easonableness is the underpinning of the concept of negligence, not the concept of recklessness."

[19/] Section 105(c)(4) provides that civil money penalties for conduct that does not meet the standards set forth in Section 105(c)(5) of the Act are limited to $100,000 against an individual and $2 million against a registered firm.

Respondents correctly note that in this context recklessness is defined as an extreme departure from the standards of ordinary care that presents a danger to investors or the markets that is either known to the actor or is so obvious that the actor must have been aware of it.[20/] Respondents' conduct easily satisfies this standard. The record is replete with examples of Respondents' extreme departures from the standard of ordinary care.

Hatfield was an experienced auditor who specialized in auditing "microcap" and "nanocap" companies like Epicus and Bidville. In auditing Epicus in 2004, Respondents knew that the company's revenue recognition practice was not in conformity with GAAP. Respondents also knew that Epicus had, nevertheless, employed the same practice in preparing its FY 2004 financial statements. They further knew that in order to express an opinion that Epicus's financial statements were fairly presented, they were required to evaluate whether the GAAP departure caused a material misstatement under GAAP. In spite of this, Respondents issued an unqualified opinion without having conducted any meaningful materiality assessment.

In the same audit, Respondents declined to send confirmation requests without any reasonable basis for their failure to do so. In attempting to perform alternative procedures to confirm the existence of Epicus's accounts receivable, Respondents failed to match cash receipts to specific receivables and relied on untested representations from Epicus' management. These facts reflect much more than a mere disagreement about "judgment" or documentation. They demonstrate that Respondents' conduct in connection with the 2004 Epicus audit was at least reckless.

Respondents' conduct during the Bidville audit was even more troubling. Hatfield admitted that he believed, at the time they accepted the Bidville engagement, that the company was a "scam," and that Bidville management "want[ed] to get filings into the marketplace as quick as possible so that they can do smoke-and-mirror fluffing press releases to pump the stock." Yet, Respondents acquiesced in the company's filing of a review report that Respondents knew was false and misleading. Respondents claim

[20/] See Gately & Assoc., Exchange Act Rel. No. 62656 (Aug. 5, 2010). Respondents argue that there is no evidence to support the conclusion that, assuming Respondents were reckless, there was "a danger of misleading anyone who reviewed and relied upon Respondents [sic] opinions." But contrary to Respondents' claim that this case does not involve audit failure, the facts, as described above, show that Respondents issued audit reports without performing sufficient procedures or gathering sufficient evidence to support the unqualified opinions they expressed. Respondents also allowed a client to file a review report that they knew contained a false statement. Such conduct presents a grave risk to investors. Respondents also argue that there was no evidence that the financial statements they audited were materially incorrect, but that is irrelevant to our determination of whether Respondents conduct was at least reckless.

that their acquiescence was based on the company's agreement that it would amend its filing within five days. But even assuming that to be the case, Respondents' contention that they originally meant to go along with the misleading of investors for only five days is not helpful to them on the question of whether their conduct rises to the level of recklessness. Their own assertions make plain that their conduct in this regard was intentional and knowing, as was their conduct, even after the initial five-day period, in continuing to allow investors to be misled for more than two months before withdrawing.

Having determined that we may, consistent with the Act and the Board's rules, impose a revocation and bar does not alone answer the question of what sanctions are appropriate for the violations in this case. We separately address that issue here.

Respondents argue that the penalties imposed by the hearing officer in this case are more severe than sanctions imposed in cases that, they claim, included more egregious conduct. According to Respondents, this case is different from the Board's other cases because this matter involves "sufficiency of the work papers, or the auditors [sic] judgment in utilizing alternative procedures to verify and test various components of the audit." Accordingly, Respondents claim that the sanctions imposed by the hearing officer are excessive, unmerited, and punitive.

In determining an appropriate sanction, our goal is to protect the investing public. For reasons already described, we do not credit Respondents' argument that this case is about the sufficiency of Respondents' workpapers or their exercise of judgment. We have found that, among other things, Respondents "rolled over"—as they described it—in allowing a company that they believed was a "scam" to file a review report that they knew was misleading. This conduct is a violation of so fundamental an obligation that it alone demonstrates Respondents' unfitness to audit public companies. But it is not the only conduct at issue, and numerous other violations resulted from conduct of Respondents that was at least reckless.[21/] If Respondents are allowed to continue to audit public companies, they will have opportunities for similar violations in the future.

Not only does Respondents' argument about the severity of the sanctions rest on a characterization of their conduct that is at odds with our findings, it also overstates the potential relevance of comparisons to the other cases they cite, all of which were settled. As the SEC has noted, "the appropriate sanction depends on the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings."[22/] Under the facts and

[21/] We also find that Respondents engaged in repeated instances of conduct that was at least negligent, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

[22/] See, e.g., Ronald Pellegrino, Exchange Act Rel. No. 59125, 2008 SEC Lexis 2843, at *68 (Dec. 19, 2008). The SEC has also noted that:

circumstances of this case, revoking the Firm's registration with the Board and barring Hatfield from association with any registered firm is not excessive, unmerited, or punitive. On the contrary, the record amply demonstrates that allowing Respondents to continue to engage in audits of issuers would pose too great a risk to investors. It is therefore in the public interest to permanently revoke the Firm's registration and to permanently bar Hatfield from associating with any registered accounting firm.[23/]

An appropriate order will issue.[24/]

By the Board.[25/]

> parties that settle disciplinary proceedings often receive less severe sanctions than those who do not. . . . [T]he sanctions that are imposed in settled cases are the result of a myriad [of] "pragmatic considerations such as the avoidance of time- and manpower-consuming adversarial litigation" that enter into decisions to accept offers of settlement from respondents. For this reason, they cannot be meaningfully compared to the sanctions imposed in litigated cases, which are the result of fact-specific considerations of various factors designed to protect the public interest.

Joseph John Vancook, Exchange Act Rel. No. 34-61039A, 2009 SEC LEXIS 3872, at *79-80 (Nov. 20, 2009) (footnotes omitted).

[23/] We decline to impose a civil money penalty on Respondents, because we are not convinced that that additional sanction, in this instance, is necessary to protect investors.

[24/] We have considered all of the parties' contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

[25/] Certain members of the Board participated in this decision without having been present for the oral argument before the Board on July 27, 2010. Pursuant to PCAOB Rule 5463(d), each such Board member reviewed the transcript of the oral argument prior to such participation.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of S.W. Hatfield, CPA
and Scott W. Hatfield, CPA

Respondents

PCAOB File No. 105-2009-003

ORDER IMPOSING SANCTIONS

February 8, 2012

On the basis of the Board's opinion issued this day it is

ORDERED that Scott W. Hatfield is permanently barred from associating with any registered public accounting firm; and it is further

ORDERED that S.W. Hatfield, CPA's registration with the Board is permanently revoked.

Effective Date of Sanctions: If a respondent does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against a respondent on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If a respondent files an application for review by the Commission or the Commission orders review of sanctions ordered against a respondent, the effective date of the. sanctions ordered against that respondent shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board.

J. Gordon Seymour
Secretary

February 8, 2012

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of *Stan Jeong-Ha Lee and Stan J.H. Lee, CPA*

Respondents.

PCAOB File No. 105-2012-001

Notice of Finality of Initial Decision

June 19, 2013

On May 9, 2013, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued an Initial Decision pursuant to PCAOB Rule 5204(b), finding that Stan Jeong-Ha Lee ("the Lee Firm"), a registered public accounting firm (as defined by Section 2(a)(12) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(9), and PCAOB Rule 1001(r)(i)), and Stan J.H. Lee, CPA ("Lee"), a person associated with that firm (as defined by Section 2(a)(9) of the Act, 15 U.S.C. 7201(9), and PCAOB Rule 1001(p)(i)), violated PCAOB Rule 4006 by improperly creating, altering, and backdating audit documentation concerning another firm's audit of the 2007 financial statements of an issuer (as defined by Section 2(a)(7) of the Act, 15 U.S.C. 7201(7), and PCAOB Rule 1001(i)(iii)), in connection with a PCAOB inspection. The Initial Decision ordered, as sanctions, that the Lee Firm's PCAOB registration be permanently revoked, that Lee be permanently barred from being an associated person of a registered public accounting firm, and that Lee pay a civil money penalty in the amount of $50,000.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final pursuant to PCAOB Rule 5204(d).

Lee shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Stan J.H. Lee, CPA as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: As to each of the two respondents, if that respondent does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against that respondent on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If a respondent files an application for review by the Commission or the Commission orders review of sanctions ordered against that respondent, the effective date of the sanctions ordered against that respondent shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

June 19, 2013

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In the Matter of Gruber & Co., LLC,
E. Randall Gruber, CPA, Stan Jeong-Ha Lee,
and Stan J.H. Lee, CPA,

Respondents.

PCAOB No. 105-2012-001

Hearing Officer – DMF

INITIAL DECISION (DEFAULT)

May 9, 2013

Summary

Respondents Stan Jeong-Ha Lee and Stan J.H. Lee, CPA ("Lee Respondents") were held in default, pursuant to Rule 5409(a)(1), for failing to attend a pre-hearing conference of which they had notice. Based upon allegations in the Order Instituting Disciplinary Proceedings that were admitted by the Lee Respondents, as well as substantiating evidence submitted by the Division of Enforcement and Investigations, the Lee Respondents violated PCAOB Rule 4006 by improperly creating, altering, and backdating audit documentation in connection with a Board inspection. For that violation, Stan Jeong-Ha Lee's registration with the Board is permanently revoked, and Stan J.H. Lee, CPA is permanently barred from being an associated person of a registered public accounting firm and ordered to pay a civil money penalty in the amount of $50,000.

INITIAL DECISION (DEFAULT)

I. Procedural History

On March 21, 2012, the Public Company Accounting Oversight Board ("PCAOB" or "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002 ("Act") and PCAOB Rule 5200(a)(1) against Respondents Gruber & Co., LLC ("G&C") and E. Randall Gruber, CPA ("Gruber") (collectively, the "Gruber Respondents"), and Stan Jeong-Ha Lee ("the Lee Firm") and Stan J.H.

Lee, CPA ("Lee") (collectively, the "Lee Respondents"). (All four Respondents are referred to herein, collectively, as "Respondents.") The OIP alleges that the Gruber Respondents violated PCAOB Rule 4006, Duty to Cooperate with Inspectors, and that they violated PCAOB Rule 3100, Compliance with Auditing and Related Professional Practice Standards, by violating Auditing Standard No. 3, Audit Documentation ("AS3"); in contrast, the OIP only alleges that the Lee Respondents violated Rule 4006. More specifically, the OIP alleges that, after being advised that the PCAOB would be conducting an inspection of G&C, the Gruber Respondents provided a misleading document and other information to the PCAOB inspectors concerning an audit of [Issuer A*] purportedly performed by G&C, in connection with the inspection of that audit. The OIP further alleges that all Respondents, and others acting on their behalf, improperly created, altered, and backdated audit documentation concerning G&C's purported audit of [Issuer A], and that all Respondents also improperly created, altered, and backdated audit documentation related to a G&C audit of [Issuer B] and a G&C audit of [Issuer C], in connection with the inspections of those audits.

The Gruber Respondents and the Lee Respondents, represented by the same counsel, filed a joint Answer to the OIP on May 1, 2012. On behalf of [the Lee Respondents], the Answer admitted the OIP's allegations regarding the [Issuer A] audit, but asserted "duress" as an affirmative defense. With regard to the [Issuer B and C] audits, the Answer asserted, on behalf of [the Lee Respondents], that the audit documents referred to in the OIP "were but paper copies of the original electronic files. None of the files were backdated, but only reflected the date the work had originally been performed and by whom." Answer at ¶¶ 55, 68.

* Note from the Office of the Secretary of the PCAOB (08/09/2013): Certain information has been redacted from the public version of this initial decision, as indicated by instances in which brackets ([ ]) are used in the document.

On June 13, 2012, the Division of Enforcement and Investigations ("Division") filed a motion for summary disposition against [the Lee Respondents], pursuant to PCAOB Rule 5427. [The Lee Respondents] filed an opposition to the Division's motion on July 5, 2012, and the Division filed a motion for leave to file a reply in support of its summary disposition motion, along with the proposed reply, on July 10, 2012.

On July 12, 2012, I issued an order granting the Division's summary disposition motion, in part, as well as the Division's motion for leave to file a reply ("July 12 Order"). In the July 12 Order, I found that there was no genuine issue as to any material fact regarding the OIP's allegations concerning [the Lee Respondents'] conduct with respect to G&C's purported audit of Issuer A, and I concluded that [the Lee Respondents'] undisputed conduct violated Rule 4006 [REDACTED]. Therefore, I granted summary disposition on those charges, subject to consideration of the purported duress defense. I denied summary disposition as to the duress defense and also denied summary disposition as to the OIP's charges that [the Lee Respondents'] conduct with respect to the documentation of G&C's [Issuer B and C] audits violated Rule 4006 [REDACTED].

At the time I issued the July 12 Order, a hearing to receive evidence relevant to [the Lee Respondents'] duress defense and the OIP's charges regarding the documentation for G&C's [Issuer B and C] audits was scheduled for the period September 11-14, 2012. On July 25, 2012, however, the parties filed a joint motion requesting that the hearing be continued indefinitely because they had "reached settlement terms in principle, and anticipate(d) finalizing a settlement in the near future" for submission to the Board. I issued an order granting the motion on July 26, 2012.

On October 15, 2012, however, the parties filed a joint status report in which they indicated that, while the Lee Respondents still expected to finalize a proposed offer of settlement for submission to the Board, the Gruber Respondents no longer planned to submit an offer of settlement. Subsequently, on November 8, 2012, the parties filed another joint status report in which they reported that the Lee Respondents had also decided not to submit a proposed offer of settlement.

Accordingly, as requested by the parties, I rescheduled the hearing to begin on January 22, 2013. On November 29, 2012, however, Respondents filed an unopposed motion to reschedule the hearing to begin on February 19, 2013. In support of the motion, Respondents' counsel, [Individual A], represented that he was scheduled to undergo heart surgery during the week of December 17, 2012. [Individual A], a sole practitioner, requested the postponement to afford him sufficient time to recover from the surgery prior to the hearing. I granted the motion on November 30, 2012.

On January 11, 2013, the Division filed a status report stating that on January 10, 2013, the Division "learned from [Individual A's] wife, that although [Individual A] had expected to be released from the hospital within fourteen days of his surgery, he is still in the hospital's intensive care unit and there is no scheduled date for his release." In light of this information, I issued an order, also on January 11, vacating the existing pre-hearing and hearing schedule and requiring Respondents to file a report, directly or through counsel, regarding the status of their representation in this proceeding by February 4, 2013. Also, in light of the information regarding [Individual A's] health provided by the Division, this order, as well as all the subsequent orders and notices discussed below, were sent directly to both Gruber, for the Gruber Respondents, and Lee, for the Lee Respondents, as well as to [Individual A], who remained Respondents' counsel of record.

On February 4, 2013, the Hearing Office received a letter from Gruber on behalf of the Gruber Respondents, but received nothing from or on behalf of the Lee Respondents. Gruber's letter stated that [Individual A] had “suffered a stroke and we understand he remains in the hospital,” but included no information regarding his prognosis for recovery. Instead, the letter requested that the hearing be postponed “for at least six (6) months” so that either [Individual A] could recover and continue his representation or the Gruber Respondents could find new counsel. On February 5, I issued an order denying that request because the Gruber Respondents had failed to provide facts regarding [Individual A’s] condition that would permit some reasonable assessment of the time required for him to recover. I therefore afforded the Gruber Respondents an opportunity to renew their request with “supporting documentation from [Individual A’s] physicians describing his current condition and prospects for recovery, including an estimate as to when he will be able to represent Respondents in this proceeding.”

On February 11, 2013, the Hearing Office received a letter from Gruber, on behalf of the Gruber Respondents, requesting reconsideration of my February 5 order. In the letter, Gruber stated that [Individual A’s] wife had informed him that “she (did) not know when [Individual A] (would) return to his legal practice and if he does, it will not be in the short term. She stated he is still unable to speak clearly and it could be ‘10 months or it could be a year before he’s able to do anything.’ We did ask if she could have [Individual A’s] current physician provide us with a letter describing [Individual A’s] condition and prognosis as directed in the Order. [Individual A’s wife] declined providing us with any written documentation citing health care privacy laws.” Once again, no communication was received from or on behalf of the Lee Respondents.

In the meantime, on February 6, 2013, the Division filed a motion seeking an order directing the Lee Respondents to show cause why they should not be held in default for failing to respond to my January 11 order. On February 12, I issued an order denying the Division’s motion, but scheduling a pre-hearing conference “for the purpose of establishing a schedule for completion of this proceeding.” The order warned all Respondents that “a failure to appear at the conference, in person or through an appropriate representative, would constitute grounds for holding the party that failed to appear in default under Rule 5409(a). Further, under Rule 5401, an individual may appear on his own behalf, or through counsel, and a partnership or corporation may appear through counsel or through a partner or an officer. Mr. Gruber, therefore, cannot represent the Lee Respondents at the conference. If the Lee Respondents fail to appear through Mr. Lee or counsel, they will be held in default." As noted above, this order was sent directly to both Gruber, for the Gruber Respondents, and Lee, for the Lee Respondents, as well as to [Individual A].

The pre-hearing conference was held by telephone conference call on March 15, 2013. Prior to the conference, new counsel filed an appearance on behalf of the Gruber Respondents, but not on behalf of the Lee Respondents. The Division and the Gruber Respondents, through their new counsel, appeared and took part in the conference, but there was no appearance by or on behalf of the Lee Respondents.[1] Accordingly, on March 19, 2013, I issued an order holding the Lee Respondents in default, pursuant to Rule 5409(a)(1), for failing to attend the pre-hearing conference, of which they had notice. In the order, I set a March 29, 2013, deadline for the Lee Respondents to file a motion to set aside their default, pursuant to Rule 5409(b), and the order was sent directly to Lee, for the Lee Respondents, as well as to [Individual A]. No motion to set aside the default, or any other response to the order, was filed by or on behalf of the Lee Respondents.

On April 9, 2013, the Division filed a motion for a default decision against the Lee Respondents. The Lee Respondents did not file any response to the Division's motion. For the reasons set forth below, the Division's motion is GRANTED.

[1] During the conference I confirmed with the Gruber Respondents' new counsel that he did not represent the Lee Respondents.

II. Facts

A. Factual Basis for Default Decision

Rule 5409(a) provides that, in the event of a default, "the hearing officer may determine the proceeding against (the defaulting) party upon consideration of the record, including the order instituting proceedings …, the allegations of which may be deemed to be true." In this case, unlike the more typical default involving a respondent's failure to file an Answer to the OIP, there is a substantial record, including [the Lee Respondents'] admissions to many of the allegations in the OIP in their Answer; the evidentiary materials included in the parties' filings in connection with the Division's motion for summary disposition; the statement of uncontested facts set forth in the July 12 Order; and additional evidentiary materials submitted by the Division in support of its motion for a default decision.

On the other hand, [the Lee Respondents] denied certain of the OIP's allegations in their Answer, and in the July 12 Order, I found that there were disputed issues of material fact that precluded a summary disposition as to [the Lee Respondents'] duress defense and as to the OIP's charges relating to the audit documentation for G&C's [Issuer B and C] 2007 audits. Both the duress defense and the allegations regarding the documentation for G&C's [Issuer B and C] 2007 audits relate to the Gruber Respondents, as well as the Lee Respondents, and, as applied to the Gruber Respondents, they will be addressed in an evidentiary hearing that has been scheduled for June 2013. As explained in greater detail below, under those circumstances, I do not find it appropriate to deem the contested allegations true for purposes of this default Initial Decision; rather, this default Initial Decision rests on the uncontested facts, as determined in the July 12 Order, as well as the absence of any factual support for a duress defense on behalf of the Lee Respondents.

B. Uncontested Facts

Rule 5421(c) provides: “Any allegation (in the OIP) not denied (in Respondents’ Answer) shall be deemed admitted.” In their joint Answer, [the Lee Respondents] admitted, or did not deny, most of the allegations in the OIP. Accordingly, as set forth in the July 12 Order, the following facts have been established for purposes of this proceeding, including this default Initial Decision:[2]

1. Respondents

- G&C is a limited liability company headquartered in Lake Saint Louis, Missouri. G&C is registered with the Board pursuant to Section 102 of the Act and PCAOB Rules. It is licensed by the Missouri State Board of Accountancy (License No. 2002009503). [REDACTED.] At all times relevant to the OIP, Gruber was the sole principal and owner of G&C, and G&C had no other audit staff. In October 2008, the Board inspected G&C’s audits of Issuer A, Issuer B, and Issuer C.

- Gruber, age 60, of Lake Saint Louis, Missouri, is the Managing Member of G&C, its sole principal and owner, and a certified public accountant licensed in the state of Missouri (License No. 006667). [REDACTED.] At all times relevant to this matter, Gruber was an associated person of G&C, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i).

- The Lee Firm is a public accounting firm headquartered in Fort Lee, New Jersey. The Lee Firm is registered with the Board pursuant to Section 102 of the Act and PCAOB Rules. At all times relevant to this matter, the Lee Firm had one principal and owner, Lee, and no audit staff.

- Lee, age 55, of Tijuana Baja California, Mexico, is the sole owner of the Lee Firm, and a certified public accountant licensed in the state of New Jersey (License No. 20CC02300900). Lee has also held a California “practice privileges” license (No. OK85457). At all times relevant to this matter, Lee was an associated person of the Lee Firm, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i). Lee conducted the Lee Firm’s concurring review of the 2007 G&C audits of [Issuer B and C] financial statements, and purportedly conducted the Lee Firm’s concurring review of the 2007 G&C purported audit of [Issuer A]. Lee earned approximately $5,000 for conducting these activities.

[2] Where [the Lee Respondents] denied a portion of an OIP allegation in their joint Answer, only the portion of the allegation not denied is deemed admitted.

2. Other Relevant Individuals and Entities

- [Individual B] is a former CPA. Although [Individual B] was not an employee of G&C, he referred work to G&C. [REDACTED.]

- [Individual C] is a non-accountant hired by G&C to assist in a number of audits performed by G&C. [Individual C] was employed by G&C at all times relevant to this matter.

- [REDACTED.] At all times relevant to this matter, [Issuer A] was an issuer as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001 (i)(iii). An audit report (the "[Issuer A] 2007 audit" report) in the name of G&C was issued in connection with [Issuer A's] April 14, 2008 Form 10-KSB filing with the Securities and Exchange Commission ("SEC" or "Commission").

- [REDACTED.] At all times relevant to this matter, [Issuer B] was an issuer as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001 (i)(iii). G&C issued an audit report (the "[Issuer B] 2007 audit" report) in connection with [Issuer B's] April 15, 2008 Form 10-KSB filing with the Commission.

- [REDACTED.] At all times relevant to this matter, [Issuer C] was an issuer as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001 (i)(iii). G&C issued an audit report (the "[Issuer C] 2007 audit" report) in connection with [Issuer C's] March 24, 2008 Form 10-KSB filing with the Commission.

3. Conduct Regarding the [Issuer A] 2007 Audit

- On April 14, 2008, [Issuer A] filed a Form 10-KSB with the Commission [REDACTED], for the year ending December 31, 2007. Included in that filing was the [Issuer A] 2007 audit report, signed by "Gruber & Company, LLC." [REDACTED.]

- The audit report release date for the [Issuer A] 2007 audit report was April 14, 2008. The documentation completion date, therefore, was May 29, 2008.

- On April 7, 2008, just prior to the issuance of the [Issuer A] 2007 audit report, the Board's Division of Registration and Inspections ("Inspections Division") confirmed with G&C, through Gruber, in writing, that it had selected G&C for inspection. Field work for the inspection was scheduled to commence in September 2008.

- On April 7, 2008, as part of the Board's notification of the inspection, the Inspections Division provided G&C with a form, entitled "Exhibit B - Issuer Information Form" ("Exhibit B"). Exhibit B required G&C to provide, among other information, a list of all audit opinions for issuers released under the firm's name between May 1, 2007 and March 31, 2008.

- Gruber completed Exhibit B and, on or about May 2, 2008, provided it to the Inspections Division. On the completed Exhibit B, Gruber represented that [Issuer A] became a client of G&C in March 2008, and that on April 7, 2008, the Firm issued an audit report on [Issuer A's] December 31, 2007 financial statements. On the completed Exhibit B, Gruber listed himself as the engagement partner for the [Issuer A] audit, indicating that he had incurred 48 hours on the audit, and that his concurring review partner had incurred six hours on that audit.

- At the time Gruber completed Exhibit B and provided it to the Inspections Division, he knew that: (a) G&C had not authorized the issuance of the [Issuer A] 2007 audit report, and (b) G&C and Gruber had not conducted any work in connection with the issuance of the [Issuer A] 2007 audit report. At no point in time did Gruber inform the Inspections Division of these facts in connection with the inspection of G&C.

- The Inspections Division was originally scheduled to visit G&C's office on September 8, 2008, to conduct a review of certain audits conducted by G&C. Gruber requested a delay of the inspection, and on August 28, 2008, the Inspections Division granted Gruber's request, and notified Gruber that it would visit G&C during the week of October 6, 2008.

- During the week preceding the Inspections Division's planned visit of G&C's office commencing on October 6, 2008, Gruber arranged for Lee, [Individual B], and [Individual C] to meet him in Missouri for a "firm retreat," held in a hotel conference room. Gruber and [Individual B] paid the travel and other expenses of Lee and [Individual C]. The firm retreat occurred from September 29, 2008 through October 8, 2008. During the firm retreat, Gruber, Lee, [Individual B] and [Individual C] met and prepared for the upcoming visit by the Inspections Division.

- Gruber asked [Individual B] to attend in order to facilitate the handover of working papers related to any opinions [Individual B] had issued under the G&C name in case the Inspections Division selected that audit and related opinion for inspection. Lee and [Individual C] were present due to their involvement in other G&C 2007 audits. [Individual C] had assisted in several audits and Lee had acted as a concurring review partner in several audits including the [Issuer B and C] 2007 audits. [REDACTED.]

- On October 3, 2008, Gruber contacted the Inspections Division to confirm the dates of its visit and to inquire about which audit engagements the Inspections Division would review. The Inspections Division confirmed the dates with Gruber, and identified to him four issuers' audits for review, including [Issuer A], [Issuer B], and [Issuer C].

- Immediately upon learning that the Inspections Division planned to examine the [Issuer A] audit, Respondent Gruber, during the firm retreat, instructed [Individual B] to provide him with all documentation for the [Issuer A] 2007 audit. [Individual B] then arranged to have [Issuer A] management provide this documentation to Gruber. According to Gruber, he received the [Issuer A] audit documentation on or about October 3, 2008. This was the first time Gruber had seen any audit documentation related to the [Issuer A] 2007 audit report.

- At the time of the firm retreat, the AS3 documentation completion date for the [Issuer A] 2007 audit report had passed.

- At the time of the firm retreat, Gruber was aware of AS3's requirements. In particular, Gruber was aware of AS3's requirement that an auditor must complete audit documentation within 45 days of an audit report release date, and that any changes to that documentation after the documentation completion date must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

- During the firm retreat Lee was also aware of AS3 and that audit documentation files must be completed 45 days after the audit report release date.

- During the firm retreat on October 3, 2008, Gruber altered, created, and backdated a set of audit working papers purporting to relate to the [Issuer A] 2007 audit report. Gruber's actions included: (a) signing-off on and backdating audit working papers that neither G&C nor Gruber prepared or reviewed in connection with issuance of the [Issuer A] 2007 audit report; (b) making handwritten entries on certain audit working papers for work that neither G&C nor Gruber had performed prior to issuance of the [Issuer A] 2007 audit report, including audit work related to Cash in Bank ("A4 Working Paper"); (c) adding a handwritten list of procedures to the A4 Working Paper; (d) permitting [Individual B] to include Gruber's initials on multiple PCAOB audit checklists including PCA-AP-1, Audit Program for Planning Procedures, and PCA-AP-2, Audit Program for General Auditing and Completion Procedures; (e) and permitting [Individual B] to include Gruber's name as G&C's Engagement Partner on PCA-CX-14.3, Engagement Completion Document.

- Gruber also instructed [Individual C] and Lee to sign and backdate certain [Issuer A] working papers. For example, regarding audit work related to Commercial Paper ("A5 Working Paper"), Gruber directed [Individual C] to sign and backdate the working paper to March 17, 2008, then Gruber himself signed the "approved by" block which he backdated to March 22, 2008. Gruber then instructed Lee to place his initials and the date March 30, 2008 on the A5 Working Paper, which Lee did.

- During the firm retreat, Gruber informed Lee that the Inspections Division planned to review the [Issuer A] 2007 audit.

- Lee assisted [Individual B] and Gruber in the creation of the following audit documentation that had not previously existed: PCA-AP-1, Audit Program for General Planning Procedures; PCA-AP-2, Audit Program for General Audit and Completion Procedures; PCA-CX-2, Financial Statement Materiality Worksheet for Planning Purposes; PCA-CX-3.1, Client Information Form; PCA-CX-3.2, Fraud Risk Information Form; PCA-CX-4.2, Understanding of Internal Control Documentation Form; PCA-CX-7.2, Risk Assessment Summary Form-Financial Statement Audit Only; PCA-CX-14.1, Supervision, Review and Approval Form; PCA-CX-14.2, Audit Documentation

Checklist; PCA-CX-14.3, Engagement Completion Document; and PCA-CX-16.1, Going Concern Checklist.

- In addition, Lee initialed and backdated to April 3, 2008, the following four documents: PCA-AP-1; PCA-AP-2; PCA-CX-2 and PCA-CX-4.2. Lee also signed an audit work paper related to the Trial Balance ("TB1 Working Paper") and backdated the document to July, 30 2008.

- At the time, Lee understood that the Inspections Division intended to inspect G&C's purported audit of [Issuer A].

- Field work for the Board's inspection occurred during the week of October 6, 2008. During the field work, Gruber and G&C presented the misleading audit working papers for the [Issuer A] 2007 audit to the Inspections Division.

- At no time during the inspection did any of the Respondents indicate to the Inspections Division that they had not performed any audit work prior to issuance of the [Issuer A] 2007 audit report, or that in October 2008, they and others had improperly created and modified audit documentation to associate with the audit report.

- Additionally, at no time during the inspection, did Gruber inform the inspection team of his belief or knowledge that [Individual B] had, without G&C's authorization, issued the [Issuer A] 2007 audit report as well as other audit reports in G&C's name that were not the subject of the Board's 2008 inspection.

- Immediately following the field work of the Inspections Division, Gruber directed Lee to prepare and backdate to March 2008, an independence letter purportedly related to the [Issuer A] 2007 audit report, which Lee did. Lee understood at the time that Gruber intended to provide the backdated independence letter to the Inspections Division. Gruber produced the backdated independence letter to the inspection team. Neither Gruber nor Lee informed the Inspections Division that this document was backdated.

- On October 30, 2009, the Inspections Division provided G&C with a draft report of its October 2008 inspection. On November 29, 2009, Gruber submitted to the Inspections Division a response to the draft inspection report. In the response, Gruber reiterated that G&C had performed an audit of [Issuer A's] 2007 financial statements.

- At no point prior to the Division's investigation into this matter did Gruber withdraw or disassociate himself or G&C from the [Issuer A] 2007 audit report. It was only in response to the Division's March 2010 request for documentation related to the [Issuer A] 2007 audit report as part of its investigation that Gruber represented for the first time to the Board that he and G&C had not been involved in the [Issuer A] 2007 audit.

- In August 2010, during Lee's testimony as part of the Division's investigation, Lee revealed for the first time to Board staff that he, Gruber, [Individual B] and [Individual

C] had created, altered and backdated audit documentation related to [Issuer A's] 2007 financial statements.

- It was not until his September 2010 testimony as part of the Division's investigation, and the Division's inquiry about the creation or modification of certain audit work papers that Gruber acknowledged that in fact, Gruber, Lee, [Individual B] and [Individual C] had created, altered and backdated audit documentation related to [Issuer A's] 2007 financial statements.

4. Conduct Regarding the [Issuer B and C] Audits

a. The [Issuer B] 2007 Audit

- G&C audited [Issuer B's] 2007 financial statements. Gruber served as the auditor with final responsibility for the engagement. Lee served as the concurring review partner.

- On April 15, 2008, [Issuer B] filed a Form 10-KSB with the Commission. The [Issuer B] 2007 audit report was included in that filing.

- The audit report release date was April 15, 2008. The documentation completion date, therefore, was May 30, 2008.

- During the October 2008 firm retreat addressed above, the Inspections Division informed Gruber that the inspection team would be examining G&C's audit of [Issuer B's] 2007 financial statements.

- At the time of the firm retreat, Gruber understood that the documentation completion date for the [Issuer B] audit had passed.

- At the time of the firm retreat, Gruber was also aware of AS3's requirements. In particular, Gruber was aware of AS3's requirement that an auditor must complete audit documentation within 45 days of an audit report release date, and that any changes to that documentation after the documentation completion date must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

- In response to learning that the Inspections Division would be examining G&C's audit of [Issuer B's] 2007 financial statements, Gruber asked Lee to "clean up" the [Issuer B] audit working papers and to memorialize Lee's concurring review work in the working papers.

- At the time Lee undertook actions with respect to the audit documentation related to the [Issuer B] 2007 audit report, he understood that the Inspections Division intended to inspect G&C's audit of [Issuer B].

- At no time prior to this investigation did Respondents disclose to the Board their actions with respect to the [Issuer B] 2007 audit documentation.

b. The [Issuer C] 2007 Audit

- G&C audited [Issuer C's] 2007 financial statements. Gruber served as the auditor with final responsibility for the engagement. Lee served as the concurring review partner.

- On March 24, 2008, [Issuer C] filed a Form 10-KSB with the Commission. The [Issuer C] 2007 audit report was included in that filing.

- The audit report release date was March 24, 2008. The documentation completion date, therefore, was May 7, 2008.

- During the October 2008 firm retreat, the Inspections Division informed Gruber that the inspection team would be examining G&C's audit of [Issuer C's] 2007 financial statements.

- At the time of the firm retreat, Gruber understood that the documentation completion date for the [Issuer C] audit had passed.

- At the time of the firm retreat, Gruber was also aware of AS3's requirements. In particular, Gruber was aware of AS3's requirement that an auditor must complete audit documentation within 45 days of an audit report release date, and that any changes to that documentation after the documentation completion date must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

- In response to learning that the Inspections Division would be examining G&C's audit of [Issuer C's] 2007 financial statements, Gruber asked Lee to help "clean up" the [Issuer C] audit working papers and to memorialize Lee's concurring review work in the working papers.

- At the time Lee undertook actions with respect to the audit documentation related to the [Issuer C] 2007 audit report, he understood that the Inspections Division intended to inspect G&C's audit of [Issuer C].

- Respondents did not disclose to the Board their actions with regard to the [Issuer C] 2007 audit documentation prior to or during the Inspections Division's inspection of G&C.

III. Violations Charged

PCAOB Rule 4006 provides, in part, that "(e)very registered public accounting firm, and every associated person of a registered public accounting firm, shall cooperate with the Board in the performance of any Board inspection."

A. The [Issuer A] 2007 Audit

The facts set forth above establish that the Lee Respondents[3] participated in the deliberate falsification of audit documentation for the [Issuer A] 2007 audit with knowledge that the falsified documentation would be submitted to PCAOB inspectors as reflecting G&C's work on the audit. Specifically, they improperly created, altered, and backdated audit documentation concerning G&C's purported audit of [Issuer A], as alleged in the OIP. The Lee Respondents thereby participated in an effort to mislead the inspectors as to the audit work that G&C had performed and the individuals who had performed it. Under Rule 4006, the Lee Respondents were required to cooperate with "any Board inspection," including the inspection of G&C. The falsification of audit documentation to mislead PCAOB inspectors as to the work performed by the firm being inspected is the antithesis of cooperation. Accordingly, I conclude that the undisputed facts establish that the Lee Respondents violated Rule 4006 by participating in the falsification of documentation regarding G&C's purported [Issuer A] 2007 audit.

[3] Although Lee personally engaged in the violative conduct discussed in this decision, Respondents' Answer admits that he was the Lee Firm's owner and sole professional employee, and the Lee Respondents have not alleged or offered any evidence that Lee's conduct was not on behalf of the Lee Firm. Accordingly, I find that both Lee Respondents are responsible for the violations discussed herein.

B. Duress Defense

In their Answer, [the Lee Respondents] "admit(ted) that Respondents and others acting on their behalf improperly created, altered and backdated audit documentation concerning (G&C's) purported audit" of [Issuer A]. They urged, however, that their conduct "would not have occurred but for the threats of physical violence by [Individual B]." Answer at ¶ 2; Answer at Affirmative Defense ¶ 1.

Under certain circumstances, duress has been recognized as a defense to criminal charges. The elements of a duress defense in that context include: (1) the defendant was under an unlawful and imminent threat of such a nature as to induce a well-grounded apprehension of death or serious bodily injury; (2) the defendant had not recklessly or negligently placed himself in a situation in which it was probable that he would be forced to perform the criminal conduct; (3) the defendant had no reasonable, legal alternative to violating the law; and (4) a direct causal relationship may be reasonably anticipated between the criminal act and the avoidance of the threatened harm. See Dixon v. United States, 548 U.S. 1, 3 n.2 (2006) ("presum(ing) the accuracy" of these elements of the defense).

The duress defense has been asserted in criminal cases. PCAOB proceedings, however, are not criminal, but rather disciplinary and remedial in nature. The purpose of such proceedings is not to punish respondents, but to protect the investing public where the evidence indicates that respondents are unwilling or unable to conform to PCAOB rules and auditing standards. Neither in their Answer nor in their opposition to the Division's motion for summary disposition did Respondents, including the Lee Respondents, cite any precedent recognizing a duress defense in any proceedings analogous to PCAOB disciplinary proceedings.

Even assuming that a duress defense might be recognized in PCAOB disciplinary proceedings, there is nothing in the record that could substantiate such a defense with respect to the Lee Respondents. Respondents' Answer asserts: "Because of threats of physical harm to Gruber, his family and friend at the 'firm retreat' and, for a lengthy period subsequent, work-papers were compiled to reflect an audit when [Individual B] had not done an audit. But for the treats (sic) of [Individual B], which were very real to those present, such would not have been done." Answer at Affirmative Defense ¶ 1. The Answer does not, however, allege that any threats were made against the Lee Respondents.

Similarly, in support of their opposition to the Division's summary disposition motion, Respondents submitted three affidavits, one signed by a husband and wife who are clients of Gruber and G&C, one signed by a friend of Gruber and his wife, and one signed by [Individual C], a non-accountant who worked on audits performed by G&C. None of the affidavits, however, sets forth any facts regarding any threats against the Lee Respondents. Further, in the portions of Lee's investigative testimony submitted by the Division in support of its motion for summary disposition, Lee did not testify that he received any threats, or that he felt under duress when participating in creating false documentation for the [Issuer A] 2007 audit, and Respondents did not submit either excerpts from Gruber's or Lee's investigative testimony or an affidavit from either individual. As a result, there is no evidence in the record that Lee's conduct in falsifying documentation for G&C's purported [Issuer A] 2007 audit was attributable to duress directed against the Lee Respondents. In particular, there is no evidence whatsoever that Lee acted under an unlawful and imminent threat of such a nature as to induce a well-grounded apprehension of death or serious bodily injury, or that he had no reasonable, legal alternative to violating the law. By defaulting, the Lee Respondents have abandoned their right to offer factual support for a duress defense in a hearing.

Accordingly, I conclude that the Lee Respondents do not have a duress defense to their violations of Rule 4006 in connection with the [Issuer A] 2007 audit.[4]

C. The [Issuer B and C] 2007 Audits

The OIP alleges that Respondents improperly created, altered, and back-dated working papers relating to the [Issuer B and C] 2007 audits prior to the Board's inspection of G&C, thereby violating Rule 4006 and, as to the Gruber Respondents, AS3. In their Answer, [the Lee Respondents] admitted a number of the OIP's allegations regarding the [Issuer B and C] 2007 audits. In particular, [the Lee Respondents] admitted that G&C performed the audits and that Lee served as the concurring review partner on the audits; that the companies filed the audit reports with the Commission; that the document completion dates for both audits were in May 2008; and that after learning during the October 2008 firm retreat that the Inspections Division was going to inspect the [Issuer B and C] audits in connection with the inspection of G&C, Gruber asked Lee to help "clean up" the working papers for both audits and to memorialize Lee's concurring review in the working papers for both audits. Further, [the Lee Respondents] admitted that at the time Lee undertook actions with respect to the working papers for both audits, he understood that the Inspections Division intended to inspect those audits, and that Respondents did not disclose Lee's actions to the Board prior to the investigation that led to this proceeding. These admissions tend to support the OIP's charges against the Lee Respondents relating to the [Issuer B and C] 2007 audits.

[The Lee Respondents] asserted in their Answer, however, that the "clean-up" that Gruber asked Lee to perform "was the printing and collation of the files from the electronic version to a paper version." OIP ¶¶ 49, 63; Answer ¶¶ 49, 63. Further, in their Answer, [the Lee Respondents] denied the OIP's allegation that Gruber provided Lee with work papers for the

[4] [REDACTED.]

[Issuer B and C] audits for the first time during the firm retreat, and the allegation that Lee initialed and back-dated those work papers. Rather, [the Lee Respondents] asserted in their Answer that the work papers Gruber presented to Lee during the firm retreat "were paper copies of working papers previously reviewed in electronic form. Dates and initials were affixed to the paper copies which were the dates the electronic files had actually been reviewed by Mr. Lee." Answer ¶ 50; see also Answer ¶¶ 51-52, 54-55, 64-68.

Other evidence in the record tends to contradict assertions in the Answer. For example, in their Answer, [the Lee Respondents] denied the OIP's allegation that "(p)rior to the release of the [Issuer B] (2007) audit report, Lee had only seen a fraction of (the) working papers related to the [Issuer B] 2007 audit, and had not signed or initialed any of them." Instead, [the Lee Respondents] asserted that "(p)rior to the release of the audit report, Mr. Lee had reviewed the electronic work-papers, not the subsequent paper work-papers which were subsequently printed from the electronic file." OIP ¶ 45; Answer ¶ 45. The record, however, includes excerpts from Lee's investigative testimony in which Lee appears to have admitted that he affixed his initials and false March 2008 dates to audit documentation that he did not see until September or October 2008.

In its motion for a default decision, the Division does not directly address the significance of the assertions set forth in Respondents' Answer. Rather, the Division simply urges that I deem the allegations in the OIP true, as permitted by Rule 5409(a), offering portions of Lee's investigative testimony and certain working papers as support for some allegations. I am reluctant to adopt that approach, however, because the allegations regarding the [Issuer B and C] 2007 audits, and Respondents' denials and assertions in response to those allegations in their Answer, also apply to the Gruber Respondents, who have not defaulted and are contesting the charges. If I were to simply deem the allegations regarding the [Issuer B and C] 2007 audits true as to the Lee Respondents, in spite of the denials and assertions in the Answer, there would be a risk that this default Initial Decision would then rest on factual findings that would prove to be inconsistent with the facts as determined in the Initial Decision that will be issued with respect to the Gruber Respondents after an evidentiary hearing. Any such inconsistencies could call into question the soundness of this default Initial Decision, and perhaps provide grounds for reopening it.

As I explained during the March 15 conference, to avoid the risk of such inconsistencies, I would normally delay issuing this default Initial Decision until after issuing the Initial Decision as to the Gruber Respondents, so that the two decisions could be harmonized. Although the Division agreed with that approach during the March 15 conference, the Division subsequently requested that I issue the default Initial Decision against the Lee Respondents immediately, arguing that because the Lee Respondents are continuing to issue audit reports for issuers, prompt issuance of the default Initial Decision is needed to avoid an ongoing risk to the investing public. In support of this argument, the Division submitted materials showing that from March 2012 through March 2013, the Lee Respondents issued more than 20 audit reports for issuers, for which they charged more than $400,000 in audit fees.

After considering all these circumstances, I have decided to issue this default Initial Decision now, as requested by the Division, but to rest it solely on the uncontested allegations establishing the Lee Respondents' violation of Rule 4006 with regard to the creation, altering, and backdating of audit documentation concerning G&C's purported [Issuer A] 2007 audit. I recognize that this approach is contrary to the normal practice of addressing all the charges in the OIP in an Initial Decision, but I believe that it is the prudent course in this case, particularly because, as set forth below, I conclude that the uncontested facts regarding the Lee Respondents' conduct in falsifying audit documentation for the [Issuer A] 2007 audit fully support the sanctions sought by the Division. Accordingly, I make no findings as to the contested allegations concerning the [Issuer B and C] 2007 audits, and therefore reach no conclusions as to the merits of the OIP's charges against the Lee Respondents regarding those audits.

IV. Sanctions

The imposition of disciplinary sanctions is governed by Sections 105(c)(4) and 105(c)(5) of the Act. Section 105(c)(4) authorizes the Board to impose a wide range of sanctions, including a temporary or permanent suspension or permanent revocation of a firm's registration, a temporary or permanent suspension or bar of a person from further association with any registered public accounting firm, or a civil money penalty. Pursuant to Section 105(c)(5), a firm's registration may be suspended or revoked and a person may be suspended or barred from association with any registered public accounting firm only if the violations involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." On the other hand, a civil money penalty may be imposed without such a finding, so long as the penalty does not exceed the amount set forth in Section 105(c)(4)(D)(i) of the Act, as adjusted. In this case, the Division requests that the Lee Firm's registration be permanently revoked, that Lee be permanently barred from further association with any registered public accounting firm, and that Lee be ordered to pay a $50,000 civil money penalty, an amount that falls within the adjusted limits of Section 105(c)(4)(D)(i) of the Act.

The undisputed facts regarding the Lee Respondents' conduct in falsifying audit documentation for the [Issuer A] 2007 audit, as set forth above, justify the imposition of the sanctions requested by the Division. The Lee Respondents have admitted that Lee intentionally created, altered, and backdated working papers to substantiate G&C's purported [Issuer A] 2007 audit, knowing that the Board's Inspections Division planned to inspect that audit as part of its inspection of G&C.

The inspections process is an integral part of the Board's responsibilities under the Act. Section 104(a) of the Act requires the Board to "conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers." The integrity of the audit documentation for the audits selected by PCAOB inspectors for inspection is plainly critical to the Board's fulfillment of this statutory responsibility. The Lee Respondents' conduct—assisting in the preparation of false audit documentation for the [Issuer A] 2007 audit—compels the conclusion that the Lee Respondents lack the integrity required of registered public accounting firms. As a result, the Lee Respondents pose an unacceptable risk to investors who may rely on audits of issuers that the Lee Respondents perform, or claim to perform. In that regard, as noted above, the Division has submitted materials establishing that the Lee Respondents have continued to issue numerous audit reports for issuers since this proceeding was instituted.

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has considered the factors set forth in Section 21B(c) of the Securities Exchange Act of 1934 as providing helpful and relevant guidance.

> The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or

> convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C., PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10 (footnotes omitted). The Commission has confirmed that "[a]n analysis based on Section 21B is … sufficiently flexible to be used in this context." R.E. Bassie & Co., Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

In this case, Lee's conduct involved deliberate disregard of regulatory requirements for the purpose of deceiving the Inspections Division, and, for the reasons set forth above, there is a strong need to deter both Lee and other associated persons of registered public accounting firms from such conduct in order to protect the Board's ability to fulfill its statutory responsibilities for the protection of investors. Accordingly, a civil money penalty is warranted and the penalty amount requested by the Division is appropriate.

Therefore, the Lee Firm's registration with the Board will be permanently revoked, Lee will be permanently barred from association with any registered public accounting firm, and Lee will be ordered to pay a civil money penalty in the amount of $50,000.

V. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Section 105(c)(4) and (c)(5) of the Act and Rule 5300(a), that for violating PCAOB Rule 4006, the registration of Respondent Stan Jeong-Ha Lee is permanently revoked; Respondent Stan J.H. Lee, CPA is permanently barred from further association with any registered public accounting firm; and Respondent Stan J.H. Lee, CPA shall pay a civil money penalty in the amount of $50,000.

This default Initial Decision shall become final in accordance with Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this default Initial Decision in accordance with Rule 5460(a), or the Board may, on its own initiative, order review, in which case this default Initial Decision will not become final.

David M. FitzGerald
Hearing Officer

PCAOB
Public Company Accounting Oversight Board

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of *P.S. Yap & Associates*

Respondent.

PCAOB File No. 105-2013-006

Notice of Finality of Initial Decision

May 8, 2014

On March 12, 2014, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of P.S. Yap & Associates ("the Firm") be permanently revoked and that the Firm pay a civil money penalty in the amount of $10,000.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies P.S. Yap & Associates as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an

application for Commission review or the expiration of the time period for the Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

May 8, 2014

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In the Matter of P.S. Yap & Associates,

Respondent.

PCAOB No. 105-2013-006

Hearing Officer – MBD

INITIAL DECISION (DEFAULT)

March 12, 2014

Summary

Respondent was held in default, pursuant to PCAOB Rule 5409(a), for failing to file an Answer in response to the Order Instituting Disciplinary Proceedings ("OIP"). The allegations in the OIP, which are deemed true and are also supported by evidence in the record, establish that Respondent failed to file annual reports and to pay annual fees for the years 2010, 2011, 2012 and 2013, as required by Sections 102(d) and 102(f) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rules 2200 and 2202. For these violations, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a), Respondent's registration with the PCAOB is permanently revoked and Respondent is ordered to pay a civil money penalty in the amount of $10,000.

Appearances

Noah A. Berlin, Esq., Washington, D.C., for the Division of Enforcement and Investigations.

No appearance by or on behalf of Respondent P.S. Yap & Associates.

INITIAL DECISION

1. Factual Background

On September 25, 2013, the Public Company Accounting Oversight Board (the "PCAOB" or "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") against Respondent P.S. Yap & Associates ("Respondent") pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rule 5200(a)(1). The OIP alleges that Respondent, a proprietorship located in Malaysia and registered with the Board since 2006, failed to file annual reports with the Board for the years 2010, 2011, 2012, and 2013 in violation of Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200, and failed to pay annual fees to the Board for the years 2010, 2011, 2012, and 2013 in violation of Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202. The OIP directed that proceedings be held to determine whether the allegations were true, to afford Respondent an opportunity to establish any defenses to the allegations, and, if violations were found, to determine what sanctions were appropriate pursuant to Section 105(c)(4) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a). The OIP further directed Respondent to file an Answer to the allegations contained in the OIP "within twenty (20) days after service of this Order," and also provided

> If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against that Respondent upon consideration of the record, including this Order, the allegations of which may be deemed to be true, as provided by PCAOB Rule 5409(a).

On October 3, 2013, the Board Secretary filed a "Notice of Service" stating that the OIP was served upon Respondent on September 30, 2013, by delivering a copy to Respondent's "Primary Contact," Mr. Pian Seen Yap, as identified in Respondent's most recent filing with the Board. The Notice of Service attached a copy of a FedEx Express tracking update indicating that a FedEx Express International Priority Envelope sent by the Office of the Secretary on September 25, 2013, was delivered on September 30, 2013, to the office address in Malaysia for Respondent which had been provided to the PCAOB by Respondent in email correspondence dated September 10, 2013. *See* Exhibit E-14 attached to the Declaration of Heather S. Howard ("Howard Decl.") filed December 20, 2013 in support of the Division of Enforcement and Investigations' Motion for Issuance of a Default Decision ("Default Motion") at PCAOB-PSYAP-000094.

According to the FedEx Express tracking update attached to the Notice of Service, the delivery of FedEx Shipment 796772558643 addressed to Pian Seen Yap from the PCAOB was signed for by ".Ms Mila" on September 30, 2013. As the Division of Enforcement and Investigations ("Division") notes, "Ms. Mila has a history of signing for correspondence sent by Board staff to Respondent." *See* Division of Enforcement and Investigations' Supplement to its Motion for Issuance of a Default Decision filed February 12, 2014 ("Division's Supplement"), at 3 (internal quotation marks omitted). Indeed, in September 2013, an individual named Miela Mila, whose email address is mielamila@yahoo.com, sent email correspondence to the Board's staff on behalf of Respondent. *Id.* The Division has "also copied mielamila@yahoo.com on all of its filings in this proceeding." *Id.* at 5. There is accordingly no question that Respondent has received actual notice of these proceedings.

Respondent failed to file an Answer to the OIP. On October 24, 2013, the Hearing Officer issued an Order directing Respondent to show cause why it should not be deemed to be in default pursuant to PCAOB Rule 5409(a)(2) ("Show Cause Order"). The Show Cause Order directed Respondent to file a response by November 11, 2013, and advised Respondent that if it failed to respond to the Show Cause Order within the time allowed, Respondent may be deemed to be in default, and a default decision may be issued finding that Respondent committed the violations alleged in the OIP and imposing sanctions. A copy of the Show Cause Order was sent to the Respondent by the Office of the Hearing Officer by email and by FedEx Express International Priority.

Respondent did not respond to the Show Cause Order. On November 15, 2013, the Hearing Officer issued an Order deeming Respondent to be in default pursuant to PCAOB Rule 5409(a)(2) (the "Default Order"). The Default Order directed the Division to file a motion for issuance of a default decision by December 20, 2013, addressing Respondent's violations and the appropriate sanctions for the violations. The Default Order also directed the Division to address in its motion the validity of the extra-territorial service of the OIP. A copy of the Default Order was sent to the Respondent by the Office of the Hearing Officer by email and by FedEx Express International Priority.

The Division filed the Default Motion on December 20, 2013, seeking the revocation of Respondent's registration and the imposition of a civil money penalty of $10,000. Respondent did not file any response to the Default Motion.

On January 13, 2014, the Hearing Officer directed the Division to supplement its Default Motion. The Hearing Officer found, as the Division had argued (Default Motion at 15), that the Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or

Commercial Matters, Nov. 15, 1965, 20 U.S.T. 361, T.I.A.S. No. 6638 (1969) (the "Hague Service Convention"), does not apply to service of process from the United States to Malaysia, and, accordingly, service of process in this proceeding need not comply with the Hague Service Convention. The Hearing Officer also found that, based upon the evidentiary materials submitted by the Division, it appeared that, as alleged in the OIP, Respondent has neither filed annual reports nor paid annual fees for 2010, 2011, 2012 and 2013. However, the Hearing Officer directed the Division to supplement its motion with additional information and evidence in support of the sanctions sought by the Division.

On February 12, 2014, the Division filed the Division's Supplement, providing additional information and evidence in support of the sanctions sought by the Division as directed by the Hearing Officer. Respondent did not file a response to the Division's Supplement.

For the reasons set forth below, the Division's motion for issuance of a default decision is GRANTED and the sanctions requested by the Division are imposed upon the Respondent.

2. Violations

The factual allegations in the OIP are deemed true pursuant to PCAOB Rule 5409(a). Additionally, a review of the evidentiary materials filed by the Division in support of its motion supports a determination that the OIP's factual allegations are true.[1]

[1] When making findings, the Board should not rely solely on the allegations of the OIP, but should review the evidence submitted by its staff and determine whether the evidence adequately supports the findings requested. *See Paul Gaynes*, PCAOB File No. 105-2011-006 at 2 and 2 n.1 (Initial Decision Nov. 10, 2011, Notice of Finality Jan. 3, 2012). As the SEC noted in approving the imposition of sanctions by the NASD following a default in *James M. Russen, Jr.*, Exch. Act Rel. No. 32895, 51 S.E.C. 675, 678 n.12 (Sept. 14, 1993), "The [NASD] did not base its conclusion simply on the complaint's allegations; rather, it reviewed the record evidence presented by its staff and determined that the evidence supported a finding of violation. This approach affords this Commission a basis for discharging its review function under Section 19 of the Securities Exchange Act."

Respondent is a proprietorship located in Malaysia, and is licensed to engage in the practice of public accounting by the Malaysian Ministry of Finance. *See* Exhibit E-1 to the Howard Decl. at PCAOB-PSYAP-000004. Respondent became registered with the Board on May 2, 2006, pursuant to Section 102 of the Sarbanes-Oxley Act and Board rules. *See* Exhibit E-13 to the Howard Decl. at PCAOB-PSYAP-000063. There is no evidence in the public record, however, that Respondent has ever prepared or issued any audit report with respect to any issuer, broker or dealer, as those terms are defined by the Sarbanes-Oxley Act. *See* Division's Supplement at 16-17. The Division is also unaware of any evidence that Respondent has participated in the preparation or issuance of any such audit reports in which another firm served as the principal auditor. *Id.*

Pursuant to Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2201, each registered public accounting firm is required to submit an annual report to the Board on Form 2 by June 30 of each year. In addition, pursuant to Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202, each registered public accounting firm must pay an annual fee to the Board by July 31 of each year. According to the PCAOB's electronic registration database, Respondent has failed both to file an annual report and to pay an annual fee in 2010, 2011, 2012 and 2013. *See* Exhibit E-13 to the Howard Decl. at PCAOB-PSYAP-000063.

These facts establish that Respondent violated Sections 102(d) and 102(f) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2202, as alleged in the OIP.

3. Sanctions

The Division requests that Respondent's registration be revoked and a civil money penalty of $10,000 be imposed. *See* Default Motion at 16.

The evidentiary materials submitted by the Division on December 20, 2013 in support of the Default Motion, together with the Division's Supplement, establish that, prior to the institution of these proceedings, the PCAOB's Registration Staff and the Division made numerous attempts to notify Respondent of its failure to timely file annual reports or pay annual fees, and gave Respondent multiple opportunities to withdraw from registration without penalty:

1. On August 25, 2010, the PCAOB's Registration Staff sent a letter to Respondent at the address used in Respondent's registration application ("Registered Address") by FedEx Express, reminding Respondent of its failure to file its 2010 annual report and pay its 2010 annual fee, and also providing instructions for filing a Form 1-WD to withdraw from PCAOB registration if Respondent no longer wished to be registered. *See* Exhibit E-4 to the Howard Decl. at PCAOB-PSYAP-000028-000029. The August 25, 2010 letter was delivered and signed for on September 2, 2010. *Id.* at 000030-000031.
2. On October 7, 2010, the PCAOB's Registration Staff sent an email to Respondent, requesting that Respondent confirm its current address. *See* Exhibit E-7 to the Howard Decl. at PCAOB-PSYAP-000041. In an email response dated October 7, 2010, Respondent provided a "new address" in Malaysia that was different from its Registered Address. *Id.*
3. On October 18, 2010, the PCAOB's Registration Staff sent a "Second Notice" to Respondent regarding the firm's delinquency in filing its 2010 annual report and paying its 2010 annual fee. S*ee* Exhibit E-8 to the Howard Decl. at PCAOB-PSYAP-000043-000044. The October 18, 2010 "Second Notice" was sent by FedEx Express to the address Respondent had provided in Respondent's October

7, 2010 email and was delivered and signed for on October 25, 2010. *Id.* at 000045-000046.

4. On December 17, 2010, the Division sent Respondent a charging letter by FedEx Express addressed to Respondent at Respondent's Registered Address concerning Respondent's failure to timely file its 2010 annual report and pay its 2010 annual fee. The charging letter described the basis for possible disciplinary proceedings against Respondent as a result of its delinquencies, and offered Respondent three options: become compliant by filing an annual report and paying the annual fee for 2010, submit a Form 1-WD pursuant to Rule 2107 to withdraw from Board registration, or submit a statement of position as to why the firm should not be charged in a disciplinary proceeding. The December 17, 2010 charging letter also stated that the Division would not recommend that the Board institute disciplinary proceedings if Respondent completed either of the first two options by January 17, 2011. *See* Exhibit E-9 to the Howard Decl. at PCAOB-PSYAP-000047-000049. The December 17, 2010 charging letter was delivered and signed for on December 27, 2010. *Id.* at 000050-000051.

5. On July 12, 2012, the Division sent a second charging letter to Respondent at Respondent's Registered Address, this time concerning Respondent's failure to timely file its 2011 annual report and pay its 2011 annual fee. The July 12, 2012 charging letter, like the December 17, 2010 charging letter, described the basis for instituting disciplinary proceedings and offered Respondent three options: become compliant, withdraw from Board registration or submit a statement of position. The July 12, 2012 charging letter also indicated that the Division would not

recommend that the Board institute disciplinary proceedings if Respondent completed either of the first two options by August 2, 2012. *See* Exhibit E-10 to the Howard Decl. at PCAOB-PSYAP-000052-000054. The July 12, 2012 charging letter was delivered and signed for on July 18, 2012. *Id.* at 000055-000056.

6. On September 6, 2012, the PCAOB's Registration Staff sent a letter to Respondent, reminding Respondent of its failure to file its 2012 annual report and pay its 2012 annual fee, and also providing instructions for filing a Form 1-WD to withdraw from PCAOB registration if Respondent no longer wished to be registered. *See* Exhibit E-11 to the Howard Decl. at PCAOB-PSYAP-000057-000058. The September 6, 2012 letter was delivered and signed for on September 10, 2012. *Id.* at 000059.

7. On October 16, 2012, the PCAOB's Registration Staff sent a "Second Notice" to Respondent regarding the firm's delinquency in filing its 2012 annual report and paying its 2012 annual fee. S*ee* Exhibit E-12 to the Howard Decl. at PCAOB-PSYAP-000060-000061. The October 16, 2012 "Second Notice" was delivered and signed for on October 19, 2012. *Id.* at 000062.

8. On September 5, 2013, the PCAOB's Registration Staff sent a letter to Respondent at Respondent's Registered Address by FedEx Express, reminding Respondent of its failure to file its 2013 annual report and pay its 2013 annual fee, and also providing instructions for filing a Form 1-WD to withdraw from PCAOB registration if Respondent no longer wished to be registered. *See* Exhibit E-16 to the Supplemental Declaration of Heather S. Howard filed February 12, 2014 in

support of the Division's Supplement, at PCAOB-PSYAP-000096-000097. The September 5, 2013 letter was delivered and signed for on September 10, 2013. *Id.* at PCAOB-PSYAP-000098.

9. On September 10, 2013, Respondent sent an email with the subject line "URGENT.. Non-Compliance with PCAOB Board Rules" to the PCAOB's Registration Staff "Regarding … your letter dated September 5, 2013 sent to our company." Respondent's September 10, 2013 email requested the Registration Staff's assistance in accessing the Board's electronic registration system ("we would like to request user ID and Password to access into the system") and also informed the Registration Staff that Respondent had a new company name ("P.S. Yap, Azlan Abas & Wong") as well as a new mailing address.[2] *See* Exhibit E-14 to Howard Decl. at PCAOB-PSYAP-000094-000095. Respondent's September 10, 2013 email to the PCAOB's Registration Staff was sent from the mielamila@yahoo.com email address. *Id.* at 000094.

10. On September 10, 2013, the PCAOB's Registration Staff provided Respondent with written guidance by email as to how to report a change in firm name and address to the Board. *See* Affidavit of Sarah J. Williams filed February 12, 2014 in support of the Division's Supplement ("Williams Aff.") at ¶¶ 3-4; Exhibit E-1 to the Williams Aff. at PCAOB-PSYAP-000099. The PCAOB's Registration Staff also sent additional emails to Respondent on September 10 and 11, 2013, providing Respondent with the user name assigned to Respondent in the Board's electronic registration system and a temporary password in order to enable

[2] When the Board instituted these proceedings on September 25, 2013, the OIP was served on Respondent by FedEx Express at the address in Malaysia provided by Respondent in Respondent's September 10, 2013 email.

Respondent to access the system. The PCAOB's Registration Staff also invited Respondent to contact the PCAOB's Registration Staff by telephone or email with any further questions. *Id.* at ¶¶ 5-8; *see* Exhibits E-2, E-3, E-4 and E-5 to the Williams Aff. at PCAOB-PSYAP-000101-000109. The Registration Staff's records reflect the receipt of no further written or oral communications from Respondent subsequent to September 11, 2013. *See* Williams Aff. ¶ 9.

A. Revocation of Registration

The Division has submitted ample evidence to establish that Respondent's registration should be suspended or revoked pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act.[3] When Respondent voluntarily registered with the Board, it accepted the responsibility of every registered accounting firm to file annual reports and pay annual fees. Respondent's failure to file an annual report or pay an annual fee for four consecutive years reflects, at a minimum, repeated instances of negligent conduct, each of which constitutes a violation of the Sarbanes-Oxley Act and the Board's rules.[4]

After registering, Respondent apparently changed its name as well as its office address without timely advising the Board. As a result, some of the PCAOB Registration Staff's efforts

[3] Pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act, to warrant a temporary suspension or permanent revocation of registration, a respondent's conduct must have involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."

[4] The Division contends that "Respondent is on actual notice of its delinquency and acted intentionally or recklessly in failing to make the required filings and pay required fees." Division's Supplement at 1. However, as the Division also notes, under the Sarbanes-Oxley Act it is unnecessary to find that Respondent's conduct was intentional, knowing or reckless to impose the sanctions requested by the Division, as a finding of multiple acts of negligence is sufficient. *Id.*

to contact Respondent about its delinquencies may not have been successful. Ultimately, however, Respondent received notices sent by the Registration Staff and the Division and was advised of options that would have allowed Respondent to avoid disciplinary action.

In light of these facts, the permanent revocation of Respondent's registration is appropriate. Respondent's violations continued for several years, even after Respondent was given options for curing them, which indicates that Respondent is unwilling or unable to conform to PCAOB requirements. Moreover, Respondent's failure to participate in this proceeding suggests that Respondent may lack the intent or ability to conform to the Board's requirements.

B. Civil Monetary Penalty

Sections 105(c)(4)(D)(ii) and 105(c)(5) of the Sarbanes-Oxley Act specify maximum civil monetary penalty amounts, and these specified amounts are subject to periodic penalty inflation adjustments as published in the Code of Federal Regulations as required by the Debt Collection Improvement Act of 1996. For conduct occurring after March 3, 2009, the Sarbanes-Oxley Act penalty provisions, as adjusted, authorize the Board to impose a civil money penalty of up to $900,000 for a natural person and up to $17,800,000 for other persons if a violation was committed intentionally or knowingly, including recklessly, or included repeated acts of negligent conduct. *See* 17 C.F.R. § 201.1004 Table IV; *Larry O'Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 14. For violations after March 5, 2013, the comparable maximum adjusted amounts are $950,000 for a natural person and $18,925,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V. For violations after March 3, 2009, that do not involve intentional or knowing (including reckless) conduct or repeated instances of negligence, the Board may impose a maximum civil money penalty of $120,000 for a natural person and

$2,375,000 for other persons (*see* 17 C.F.R. § 201.1004 Table IV); for violations after March 5, 2013, the comparable maximum adjusted amounts are $130,000 for a natural person and $2,525,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V; *see also Stan Jeong-Ha Lee*, PCAOB No. 105-2012-001, at 21 (May 9, 2013) ("[A] civil money penalty may be imposed without such a finding [of intentional or knowing conduct, including reckless conduct, or multiple acts of negligence], so long as the penalty does not exceed the amount set forth in Section105(c)(4)(D)(i) of the Act, as adjusted").

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has stated that it is "guided by the statutorily prescribed objectives of any exercise of [its] sanctioning authority: the protection of investors and the public interest." *Larry O'Donnell, CPA, P.C.*, at 9 (citations omitted). The Board has also stated that it will consider the factors set forth in Section 21B(c) of the Securities Exchange Act of 1934, as amended, which apply to the imposition of civil money penalties by the Securities and Exchange Commission ("Commission") in administrative proceedings, as providing helpful and relevant guidance:

> The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Id. at 9-10 (citation and footnotes omitted). The Commission has confirmed that "[a]n analysis based on Section 21B is … sufficiently flexible to be used in this context." *R.E. Bassie & Co.*, Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

In this case, there is no evidence that Respondent prepared, issued or participated in the preparation or issuance of audit reports for issuers, brokers or dealers, and thus no evidence that Respondent's conduct directly or indirectly harmed other persons. There is also no evidence that Respondent has a prior disciplinary history. However, Respondent's conduct involved repeated instances of at least negligent disregard of its obligations as a registered accounting firm for an extended period of time. Further, by failing to pay annual fees, Respondent has been unjustly enriched. Finally, there is a need to deter not only Respondent but also other registered accounting firms from engaging in similar conduct in order to protect investors and the public interest.

Taking all of the relevant circumstances into consideration, the $10,000 civil money penalty sought by the Division is appropriate to accomplish the Board's remedial objectives in this proceeding. While this is well below the maximum penalty that could be imposed, it nonetheless reflects the seriousness of the violations.

4. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and Rule 5300(a), that for violating Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200 by failing to file annual reports for 2010, 2011, 2012 and 2013, and for violating Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202 by failing to pay an annual fee for 2010, 2011, 2012 and 2013, the registration of

Respondent P.S. Yap & Associates is permanently revoked. Additionally, Respondent P.S. Yap & Associates shall pay a civil money penalty in the amount of $10,000.

This Initial Decision will become final in accordance with PCAOB Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision by filing a petition for review in accordance with PCAOB Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

Dated: March 12, 2014

Marc B. Dorfman
Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Ron Freund, CPA,

Respondent

PCAOB File No. 105-2009-007

ORDER SUMMARILY AFFIRMING FINDING OF VIOLATION AND IMPOSITION OF SANCTION

January 26, 2015

This proceeding is before the Board on Respondent Ron Freund's petition for review of the hearing officer's initial decision. The initial decision found that Freund violated PCAOB Rules 3100 and 3200T by failing to comply with a provision of PCAOB auditing standards in connection with the audit of the consolidated financial statements of Taro Pharmaceutical Industries Ltd. (Taro) for the year ending December 31, 2004, and, for that violation, the decision imposed the sanction of a censure. Against the background described below, including that Freund has since effectively rendered his petition for review moot and stated that he accepts the initial decision, we summarily affirm the finding of the violation and the imposition of the censure.

The initial decision found the following facts to be undisputed. At all relevant times, Taro was an issuer, as defined by Section 2(a)(7) of the Sarbanes-Oxley Act, 15 U.S.C. 7201(7), and PCAOB rules. Freund was a person associated with a registered public accounting firm—Kost Forer Gabbay & Kasierer—as defined by Section 2(a)(9) of the Act, 15 U.S.C. 7201(9), and PCAOB rules. Kost Forer audited Taro's consolidated financial statements for the year ending December 31, 2004. Freund was the Kost Forer lead engagement partner on that audit. In that audit, Kost Forer used the work of another independent auditor in circumstances to which AU § 543, *Part of Audit Performed by Other Independent Auditors*, applied. Kost Forer did not refer to the other auditor in its audit report expressing an unqualified opinion on Taro's 2004 financial statements. That audit report, dated February 23, 2005, was included in Taro's Form 20-F filed with the Securities and Exchange Commission on June 30, 2005.

AU § 543.12 states, in part, "When the principal auditor decides not to make reference to the audit of the other auditor, in addition to satisfying himself as to the matters described in" AU § 543.10—matters not at issue here—"the principal auditor must obtain, and review and retain, the following information from the other auditor:...b. A list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures....The principal auditor must obtain, and review and retain, such documents prior to the report release date" (footnote omitted). The Order Instituting Disciplinary Proceedings alleged that Freund "never obtained any evidence concerning whether [the other independent auditor] performed any retrospective review of prior year estimates [of sales allowances, including chargebacks, as part of the audit work used by Kost Forer], although auditing standards required the performance of such a review," and that Freund's "failure to do so violated" AU § 543.12.b. AU § 316.64 provides that an auditor "should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year." It is undisputed that a retrospective review relates to the risk of fraud. The review's purpose is to determine whether management judgments and assumptions relating to the estimates indicate a possible bias, as a means of obtaining additional information about possible management bias in making the current year's estimates.

The initial decision determined that although Freund had cited information that may have supported an inference that the other independent auditor had performed the retrospective review, this was not direct evidence, or a clear description, of the results of that procedure and was not enough to satisfy the obligation under AU § 543.12.b to obtain, and review and retain, the results of the other auditor's procedures relating to fraud risk factors. The decision found that Freund violated AU § 543.12.b through a single instance of negligent conduct. It ordered that he be censured for that conduct.

Freund filed a Petition for Review that took exception to the initial decision's disposition of this charge. A subsequent brief filed on Freund's behalf, however, stated that "[a]lthough Mr. Freund disagrees with the Hearing Officer's conclusion that he violated AU § 543.12.b, he is willing to accept that decision" and no longer seeks Board review of that ruling. In light of that statement, the Board finds that the issue raised by Freund's petition for review does not warrant further consideration. We summarily affirm the initial decision's finding that Freund violated AU § 543.12.b. We also summarily affirm the initial decision's imposition of a censure as an appropriate sanction for that conduct. *See* PCAOB Rule 5460(e).

To avoid any misimpression that issuance of this order and our summary affirmance of the initial decision might create, we think it appropriate to make clear that we affirm the initial decision only to the extent of its disposition of these matters, not to the extent it may offer or suggest a larger interpretation of AU § 543 that is unnecessary to such disposition. The initial decision, in an introductory discussion of AU § 543 that preceded its finding that Freund had violated AU § 543.12.b and its imposition of the censure, used language that seemed to indicate that Freund's responsibilities with respect to use of the other independent auditor's work were set forth exclusively by AU § 543. In circumstances to which AU § 543 applies and no reference is made to the other auditor, the principal auditor must comply with certain provisions of AU § 543, and the engagement partner for the principal auditor is responsible for the principal auditor's compliance with the requirements of AU § 543. But to broadly suggest, as the language in the initial decision might, that those are the engagement partner's only responsibilities with respect to use of the other auditor's work, as if the engagement partner automatically or inevitably satisfies them solely by taking the steps listed in AU § 543.10 and § 543.12, fails to situate the responsibilities within the context of the overall audit.

In the circumstances described, the other auditor's work "relates to the principal auditor's expression of an opinion on the financial statements taken as a whole." AU § 543.03 & .04. The obligations imposed by AU § 543 cannot artificially be divorced from the objective of the use of the work and report of the other auditor or the nature of the review of the information required to be reviewed by the principal auditor. Moreover, to carry out those obligations, professional judgment must be exercised by and on behalf of the principal auditor,[1/] and the exercise of professional judgment "must be 'guided by sound' auditing principles." *McCurdy v. SEC*, 396 F.3d 1258, 1263 (D.C. Cir. 2005).

The engagement partner for the principal auditor performs his or her role against the background of all PCAOB standards. This means, among other things, that the obligations described in AU § 543 must be carried out with the due care, including professional skepticism, required by AU § 230. That, in turn, means that the engagement partner must respond appropriately, including with a questioning mind engaged in a critical assessment (AU § 230.07), to indications that the other independent auditor's work does not comply with PCAOB standards. Thus, when the engagement partner for the principal auditor receives information about part of an entity's financial statements through documentation about the audit work of another independent auditor, he or she may not abandon "an attitude that includes a questioning mind and a critical assessment of" the audit evidence that they receive in that form and may not forego "objective evaluation" of such evidence in trying to "obtain sufficient competent evidential matter" to provide "a reasonable basis for forming an opinion" on the entity's financial statements as a whole. *E.g.*, AU §§ 230.07, 326.22.

Nor, for example, may the engagement partner for the principal auditor simply deflect to the other auditor all responsibility for any matter that raises substantial doubt about a financial statement assertion of material significance (AU § 326). Nothing in AU § 543 absolves that engagement partner from taking appropriate steps as necessary to meaningfully understand and appropriately address information relating to significant audit issues of which he or she is aware in the other auditor's work. Taking such steps is contemplated by AU § 543.13 itself, for example, which states that the principal

[1/] *E.g.*, AU §§ 543.01 & .04 (where reference not made to other auditor's work, principal auditor exercises "professional judgment[ ]" about whether to use that work based not only on "the independence and professional reputation of the other auditor (see paragraph .10)" but also on "tak[ing] steps he considers appropriate to satisfy himself as to the audit performed by the other auditor (see paragraph .12)"); § 543.12 (principal auditor must review certain information from other auditor, including an engagement completion document identifying "all significant findings or issues," such as "[c]ircumstances that cause significant difficulty in applying auditing procedures" (Auditing Standard No. 3 ¶¶ 12 & 13), and information relating to significant findings or issues that are "inconsistent with or contradict the auditor's final conclusions," and "[i]n addition," "should consider performing one or more" specified procedures related to obtaining a more detailed understanding of the other auditor's work).

auditor "may consider it appropriate" to "make supplemental tests" of financial statement accounts that are assigned to the other auditor and that "[t]he determination of the extent of additional procedures, if any, to be applied rests with the principal auditor alone in the exercise of his professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work." In addition, AU § 543.10 provides that the principal auditor "should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements," and various other standards may bear on what is "appropriate" in that regard.[2]

To the extent anything in the initial decision might suggest a contrary interpretation of AU § 543 on these larger points, we reject it.

Accordingly, it is ORDERED that Ron Freund is censured.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board (Board Member
Ferguson not participating).

Phoebe W. Brown
Secretary

January 26, 2015

[2] Our discussion here quotes language and employs citations of standards in place at the time of the conduct at issue in this proceeding. Since that time, the Board has issued new standards that supersede or amend some of the standards quoted or cited in this order. The principles discussed here also apply to audits conducted under current PCAOB standards.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Joseph Troche, CPA,

Respondent.

PCAOB File No. 105-2014-007

Notice of Finality of Initial Decision

March 6, 2015

On January 12, 2015, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Joseph Troche, CPA ("the Firm") be permanently revoked and that the Firm pay a civil money penalty in the amount of $5,000. Additionally, the Chief Hearing Officer censured the Firm.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final as to Joseph Troche, CPA pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Joseph Troche, CPA as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an

application for Commission review or the expiration of the time period for the Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

March 6, 2015

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In the Matter of Joseph Troche, CPA, Respondent.	PCAOB No. 105-2014-007 Hearing Officer – MBD **INITIAL DECISION** January 12, 2015

Summary

The evidence in the record establishes that Respondent failed to timely file annual reports for 2013 and 2014 and failed to pay annual fees for 2012, 2013 and 2014 as required by Sections 102(d) and 102(f) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rules 2200 and 2202. Accordingly, the motion by the Division of Enforcement and Investigations for summary disposition is granted. Pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a), Respondent is censured, Respondent's registration with the PCAOB is permanently revoked, and Respondent is ordered to pay a civil money penalty in the amount of $5,000.

Appearances

Michael C. Occhuizzo, Esq., Washington, D.C., for the Division of Enforcement and Investigations.

No formal appearance by or on behalf of Respondent Joseph Troche, CPA.

INITIAL DECISION

1. Background

On September 10, 2014, the Public Company Accounting Oversight Board ("PCAOB" or "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") against Respondent Joseph Troche, CPA ("Respondent"), pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rule 5200(a)(1). The OIP alleges that Respondent, a proprietorship located in New York, New York, and registered with the Board since 2004, failed to file annual reports with the Board for the years 2013 and 2014 in violation of Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200, and failed to pay annual fees to the Board for the years 2012, 2013 and 2014 in violation of Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202. The OIP directed that proceedings be held to determine (1) whether the allegations were true and to afford Respondent an opportunity to establish any defenses to the allegations, and (2) if violations were found, to determine what, if any, sanctions were appropriate pursuant to Section 105(c)(4) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a). The OIP further directed Respondent to file an Answer to the allegations contained in the OIP within twenty (20) days after service of the OIP upon Respondent.

On October 7, 2014, the Secretary filed a Notice of Service stating that the OIP was served upon Respondent on September 15, 2014. Accordingly, absent an extension, the deadline for Respondent to serve and file an Answer to the OIP was October 6, 2014. Respondent failed to file an Answer to the OIP by the October 6 deadline.

On October 9, 2014, the Hearing Officer issued an order directing Respondent to show cause why Respondent should not be deemed to be in default pursuant to PCAOB Rule 5409(a)(2) ("Show Cause Order"), and required Respondent to file its response to the Show Cause Order by October 30, 2014. The Show Cause Order advised Respondent that if it failed to respond within the time allowed, Respondent may be deemed to be in default, and a default decision may be issued finding that Respondent committed the violations alleged in the OIP and imposing sanctions.

As of October 31, 2014, Respondent had not formally responded to the Show Cause Order. Accordingly, on October 31, 2014, the Hearing Officer issued an order deeming Respondent to be in default pursuant to Rule 5409(a)(2), and directing the Division of Enforcement and Investigations ("Division") to file a motion for issuance of a default decision by December 1, 2014.

On December 1, 2014, the Division filed its Motion for Issuance of a Default Decision ("Default Motion"), accompanied by a Statement of Undisputed Facts and the Declaration of Heather S. Howard ("Howard Decl."). At footnote 1 of the Division's Default Motion, the Division noted that "On October 28, 2014 … Respondent filed its delinquent 2013 and 2014 annual reports."

Although Respondent had not formally appeared in this proceeding, on December 2, 2014, pursuant to Rule 5409(b), the Hearing Officer found that Respondent's October 28 filing of its delinquent 2013 and 2014 annual reports, apparently in response to the Show Cause Order, constituted good cause to set aside the default and scheduled an Initial Pre-Hearing Conference to be conducted by telephone conference call at 11:00 a.m., Eastern Time, on December 9, 2014 ("December 9 Conference"). Respondent was notified of the December 9 Conference by both email and FedEx Express. Additionally, both Division counsel and the Case Administrator delivered telephonic voice mail messages to Respondent reminding Respondent of the December 9 Conference. Respondent nevertheless failed to appear or participate in the December 9 Conference.

During the December 9 Conference the Hearing Officer ordered that the annual reports for 2013 and 2014 filed by Respondent on October 28, 2014, would be deemed to be Respondent's Answer to the OIP. Additionally, counsel for the Division stated during the December 9 Conference that documents had been made available to the Respondent for inspection and copying pursuant to PCAOB Rule 5422. Accordingly, at the request of counsel for the Division, the Hearing Officer ordered that the December 9 Conference would serve as a pre-motion conference for the Division to file a motion for summary disposition pursuant to PCAOB Rule 5427(c), and that the papers previously filed by the Division in support of its Default Motion would be considered in support of the Division's motion for summary disposition. During the December 9 Conference the Hearing Officer also discussed with counsel for the Division the Division's views as to the appropriate range of civil penalty amounts that should be assessed against registrants who fail to timely file annual reports with the Board or fail to pay annual fees to the Board.

Following the December 9 Conference, on December 12, 2014, the Hearing Officer issued an Order deeming Respondent's filing of its annual reports to constitute Respondent's Answer to the OIP (the "December 12 Order"). The December 12 Order also directed that the Division file and serve by December 18, 2014, a written request that its previously-filed Default Motion be treated as a motion for summary disposition pursuant to PCAOB Rule 5427 and, additionally, "any supplementary information the Division wishes to provide as to the appropriate amount of a civil monetary penalty, if any, to be assessed against Respondent." The December 12 Order also directed Respondent to file a response to the Division's Motion for Summary Disposition by January 8, 2015.

On December 18, 2014, the Division filed its Motion for Summary Disposition, requesting that its previously-filed Default Motion and supporting materials be treated as a motion for summary disposition and seeking summary disposition of these proceedings pursuant to PCAOB Rule 5427. According to the Division, the undisputed facts demonstrate that Respondent violated the Sarbanes-Oxley Act and the Board's rules by failing to timely file annual reports and failing to pay annual fees. The Division's Motion for Summary Disposition recommended Respondent's censure, revocation of Respondent's registration, and the imposition of a civil monetary penalty of $5,000.

Respondent did not file a response to the Division's Motion for Summary Disposition. For the reasons set forth below, the Division's Motion for Summary Disposition is GRANTED and the sanctions requested by the Division are imposed upon the Respondent.

2. Violations

Pursuant to PCAOB Rule 5427(d), a motion for summary disposition may be granted "if the pleadings, depositions and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to disposition as a matter of law." The evidentiary materials filed by the Division show that there can be no genuine dispute that Respondent has violated the

Sarbanes-Oxley Act and the Board's rules.

Pursuant to Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2201, each registered public accounting firm is required to submit an annual report to the Board on Form 2 by June 30 of each year. In addition, pursuant to Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202, each registered public accounting firm must pay an annual fee to the Board by July 31 of each year.

According to the PCAOB's electronic registration database, Respondent is a proprietorship located in New York, New York, and became registered with the Board on August 27, 2004, pursuant to Section 102 of the Sarbanes-Oxley Act and Board rules. *See* Exhibit E-7 to the Howard Decl. Additionally, according to the PCAOB's electronic registration database, Respondent failed to file its annual reports for 2013 and 2014 until October 28, 2014, and failed to pay its annual fees for 2012, 2013 and 2014. *Id.*

The evidentiary materials submitted by the Division also establish that, prior to the institution of these proceedings, the PCAOB's Staff made numerous attempts to notify Respondent of its failure to timely file annual reports or pay annual fees, and gave Respondent multiple opportunities to withdraw from registration without penalty:

1. On September 5, 2013, the PCAOB's Registration Staff sent a letter to Respondent at the address used in Respondent's registration application ("Registered Address") by FedEx Express, reminding Respondent of its failure to file its 2013 annual report and pay its 2013 annual fee, and also providing instructions for filing a Form 1-WD to withdraw from PCAOB registration if Respondent no longer wished to be registered. *See* Exhibit E-2 to the Howard Decl. at PCAOB-TROCHE-000022-23. The September

5, 2013 letter was delivered and signed for on September 6, 2013. *Id.* at PCAOB-TROCHE-000024.

2. On September 9, 2013, the PCAOB's Registration Staff sent an email to Respondent, advising Respondent that if the "firm no longer wishes to be registered with the PCAOB, it should electronically submit a complete Form 1-WD to the Board…." *See* Exhibit E-4 to the Howard Decl. at PCAOB-TROCHE-000029.

3. On September 24, 2013, the PCAOB's Registration Staff telephoned Respondent to follow up on Respondent's failure to file its annual report for 2013. According to the Call History for Registrant #1127 – Joseph Troche, CPA, maintained by the PCAOB's Registration Staff as a business record, during that telephone call Mr. Troche stated that he "forgot" about filing the 2013 annual report but that he would "…work on it"; Mr. Troche also stated that he was experiencing "a financial situation" but would "try to come up with $1,000 for the fee." *See* Exhibit E-8 to the Howard Decl. at PCAOB-TROCHE-000073.

4. On December 6, 2013, a member of the PCAOB's Staff sent an email to Respondent regarding Respondent's unpaid annual fees totaling $1,000 for 2012 and 2013 and reiterating that if Respondent no longer wished to be registered with the PCAOB it needed to file a Form 1-WD. *See* Exhibit E-8 to the Howard Decl. at PCAOB-TROCHE-000065-66. The December 6, 2013 email expressly noted, "There is no fee associated with filing a Form 1-WD." *Id.* at PCAOB-TROCHE-000066.

5. On January 7, 2014, Mr. Troche sent an email to the PCAOB's Registration Staff, stating, "Please accept my apology for the long delay. I was unexpectedly faced with financial hardship due to personal circumstances. I am diligently working on putting together the funds to pay all past due membership fees. Again, please accept my apologies and thank you for your patience." *See* Exhibit E-8 to the Howard Decl. at PCAOB-TROCHE-000068-69.

6. On May 8, 2014, the Division sent Respondent a charging letter by FedEx Express addressed to Respondent at Respondent's Registered Address. *See* Exhibit E-6 to the Howard Decl. at PCAOB-TROCHE-000033-35. The charging letter advised Respondent that its failure to timely file its 2013 annual report and pay its 2013 annual fee could serve as the basis for possible disciplinary proceedings against Respondent, and offered Respondent three options: (1) become compliant by filing its annual report and paying its annual fee for 2013; (2) submit a Form 1-WD to withdraw from Board registration; or (3) submit a statement of position as to why the firm should not be charged in a disciplinary proceeding. The charging letter also stated that the Division would not recommend that the Board institute disciplinary proceedings if Respondent completed either of the first two options by May 29, 2014. *Id.* at PCAOB-TROCHE-000034. The charging letter was delivered and signed for on May 12, 2014. *Id.* at PCAOB-TROCHE-000036.

These undisputed facts establish that Respondent violated Sections 102(d) and 102(f) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2202.

3. Sanctions

The Division requests that Respondent be censured, that Respondent's registration be permanently revoked and that a civil monetary penalty of $5,000 be imposed. *See* Division's Motion for Summary Disposition at 2.

A. Censure and Revocation of Registration

The Division has submitted ample evidence to establish that Respondent should be censured and that Respondent's registration should be permanently revoked pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act.[1] When Respondent voluntarily registered with the Board, it accepted the responsibility of every registered accounting firm to file annual reports and pay annual fees. Respondent's failure to timely file annual reports or pay annual fees reflects, at a minimum, repeated instances of negligent conduct, each of which constitutes a violation of the Sarbanes-Oxley Act and the Board's rules. Additionally, Respondent's violations continued for several years, even after Respondent was given options for curing them, which indicates that Respondent is unwilling or unable to conform to PCAOB requirements. Moreover, Respondent's failure to participate in this proceeding suggests that Respondent may lack the intent or ability to conform to the Board's requirements.

[1] Pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act, to warrant a temporary suspension or permanent revocation of registration, a respondent's conduct must have involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."

B. Civil Monetary Penalty

The Division also recommends a $5,000 civil money penalty against Respondent. Sections 105(c)(4)(D)(ii) and 105(c)(5) of the Sarbanes-Oxley Act specify maximum civil monetary penalty amounts, and these specified amounts are subject to periodic penalty inflation adjustments as published in the Code of Federal Regulations as required by the Debt Collection Improvement Act of 1996. For conduct occurring after March 3, 2009, the Sarbanes-Oxley Act penalty provisions, as adjusted, authorize the Board to impose a civil money penalty of up to $900,000 for a natural person and up to $17,800,000 for other persons if a violation was committed intentionally or knowingly, including recklessly, or included repeated acts of negligent conduct. *See* 17 C.F.R. § 201.1004 Table IV; *Larry O'Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 14. For violations after March 5, 2013, the comparable maximum adjusted amounts are $950,000 for a natural person and $18,925,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V. For violations after March 3, 2009, that do not involve intentional or knowing (including reckless) conduct or repeated instances of negligence, the Board may impose a maximum civil money penalty of $120,000 for a natural person and $2,375,000 for other persons (*see* 17 C.F.R. § 201.1004 Table IV); for violations after March 5, 2013, the comparable maximum adjusted amounts are $130,000 for a natural person and $2,525,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V; *see also Stan Jeong-Ha Lee*, PCAOB No. 105-2012-001, at 21 (May 9, 2013) ("[A] civil money penalty may be imposed without such a finding [of intentional or knowing conduct, including reckless conduct, or multiple acts of negligence], so long as the penalty does not exceed the amount set forth in Section105(c)(4)(D)(i) of the Act, as adjusted").

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has stated that it is "guided by the statutorily prescribed objectives of any exercise of [its] sanctioning authority: the protection of investors and the public interest." *Larry O'Donnell, CPA, P.C.*, at 9 (citations omitted). The Board has also stated that it will consider the factors set forth in Section 21B(c) of the Securities Exchange Act of 1934, as amended, which apply to the imposition of civil money penalties by the Securities and Exchange Commission ("Commission") in administrative proceedings, as providing helpful and relevant guidance:

> The factors specified in section 21B(c) include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Id. at 9-10 (citation and footnotes omitted). The Commission has confirmed that "[a]n analysis based on Section 21B is … sufficiently flexible to be used in this context." *R.E. Bassie & Co.*, Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

This is not a fraud case, nor is there any evidence of manipulative intent or deceit. Rather, this is a case where Respondent has failed to meet its statutory obligations by not paying its annual fees and by its delinquent filing of its annual reports; indeed, Respondent did not file its annual reports for 2013 and 2014 until well after these proceedings had commenced.

The Division indicates that Respondent last prepared and issued an audit report for a public issuer on February 20, 2003. *See* Default Motion at 7; *see also* Exhibit E-1 to the Howard Decl. at PCAOB-TROCHE-000005. The Division has offered no evidence that Respondent has prepared, issued or participated in the preparation or issuance of audit reports since 2003 for public issuers or brokers or dealers, and thus no evidence that Respondent's conduct directly or indirectly harmed other persons.[2] There is also no evidence that Respondent has a prior disciplinary history. However, Respondent's conduct involved repeated instances of at least negligent disregard of its obligations as a registered accounting firm for an extended period of time. Further, by failing to pay annual fees, Respondent has been unjustly enriched. Finally, there is a need to deter not only Respondent but also other registered accounting firms from engaging in similar conduct in order to protect investors and the public interest.

Taking all of the relevant circumstances into consideration, the $5,000 civil money penalty sought by the Division is appropriate to accomplish the Board's remedial objectives in this proceeding. While this is well below the maximum penalty that could

[2] The Division notes that "Certain information required to be reported [on Respondent's annual reports] is not readily available through other sources" (Default Motion at 7), and argues that "investors and the Board were indirectly harmed here by the lack of access to information about the Respondent that should have been reported annually in 2013 and 2014." The Division has failed to demonstrate that investors and the Board were in fact "indirectly harmed" by any lack of access to information about the Respondent.

be imposed, it nonetheless reflects the seriousness of the violations and is within the range of sanctions imposed in previous similar PCAOB proceedings.

4. Order

For the foregoing reasons, **IT IS ORDERED**, that the Division's Motion for Summary Disposition is GRANTED, and,

IT IS FURTHER ORDERED that, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a), for violating Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200 by failing to timely file annual reports for 2013 and 2014, and for violating Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202 by failing to pay an annual fee for 2012, 2013 and 2014, Respondent Joseph Troche, CPA, is censured and Respondent's registration with the Board is permanently revoked. Additionally, Respondent Joseph Troche, CPA, shall pay a civil money penalty in the amount of $5,000.

This Initial Decision will become final in accordance with PCAOB Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision by filing a petition for review in accordance with PCAOB Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

Dated: January 12, 2015

Marc B. Dorfman
Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of *David W. Dube*,

Respondent.

PCAOB File No. 105-2014-005

Notice of Finality of Initial Decision

November 30, 2015

On August 26, 2015, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of David W. Dube ("the Firm") be permanently revoked and that the Firm pay a civil money penalty in the amount of $10,000. Additionally, the Chief Hearing Officer censured the Firm.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final as to David W. Dube pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies David W. Dube as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an

application for Commission review or the expiration of the time period for the Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

November 30, 2015

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In the Matter of David W. Dube,

Respondent.

PCAOB No. 105-2014-005

Hearing Officer – MBD

INITIAL DECISION (DEFAULT)

August 26, 2015

Summary

Respondent was held in default, pursuant to PCAOB Rule 5409(a), for failing to file an Answer in response to the Order Instituting Disciplinary Proceedings ("OIP"). The allegations in the OIP, which are deemed true and are also supported by evidence in the record, establish that Respondent failed to file annual reports and to pay annual fees for the years 2012, 2013 and 2014, as required by Sections 102(d) and 102(f) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rules 2200 and 2202. For these violations, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a), Respondent is censured, Respondent's registration with the PCAOB is permanently revoked, and Respondent is ordered to pay a civil money penalty in the amount of $10,000.

Appearances

Noah A. Berlin, Esq., Washington, D.C., for the Division of Enforcement and Investigations.

No appearance by or on behalf of Respondent David W. Dube.

INITIAL DECISION

1. Factual Background

On September 10, 2014, the Public Company Accounting Oversight Board ("PCAOB" or the "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") against Respondent David W. Dube ("Respondent") pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rule 5200(a)(1). The OIP alleges that Respondent, a proprietorship located in Largo, Florida and registered with the Board since 2010, failed to file annual reports with the Board for the years 2012, 2013, and 2014 in violation of Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200, and failed to pay annual fees to the Board for the years 2012, 2013, and 2014 in violation of Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202. The OIP directed that proceedings be held to determine whether the allegations were true, to afford Respondent an opportunity to establish any defenses to the allegations, and, if violations were found, to determine what sanctions were appropriate pursuant to Section 105(c)(4) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a). The OIP further directed Respondent to file an Answer to the allegations contained in the OIP "within twenty (20) days after service of this Order," and also provided

> If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against that Respondent upon consideration of the record, including this Order, the allegations of which may be deemed to be true, as provided by PCAOB Rule 5409(a).

On May 13, 2015, the Office of the Secretary of the Board filed a Notice of Service stating that the OIP was served by a process server upon Respondent on December 26, 2014, in accordance with Section 48.031(6) of the Florida Statutes, by delivering the document to the person in charge of a private mailbox of Respondent's at a UPS store in St. Petersburg, Florida, discoverable through public records, after the process server determined that Respondent maintains a mailbox at that location. The Notice of Service attached an Affidavit of Service by the process server in which the process server stated that the person in charge of the UPS store to which the OIP was delivered confirmed that Respondent "actively rents a mailbox at this location" ("Respondent's UPS Store Address").

Based on the foregoing, Respondent received actual notice of this proceeding.

Respondent failed to file an Answer to the OIP. On May 14, 2015, the Hearing Officer issued an Order directing Respondent to show cause why it should not be deemed to be in default pursuant to PCAOB Rule 5409(a)(2) ("Show Cause Order"). The Show Cause Order directed Respondent to file a response by June 15, 2015, and advised Respondent that if it failed to respond to the Show Cause Order within the time allowed, Respondent may be deemed to be in default, and a default decision may be issued finding that Respondent committed the violations alleged in the OIP and imposing sanctions. A copy of the Show Cause Order was sent to Respondent by the Office of the Hearing Officer by FedEx Express to Respondent's UPS Store Address, which was delivered and signed for on May 15, 2015.

Respondent did not respond to the Show Cause Order. On June 16, 2015, the Hearing Officer issued an Order deeming Respondent to be in default pursuant to PCAOB Rule 5409(a)(2) (the "Default Order"). The Default Order directed the Division of Enforcement and Investigations ("Division") to file a motion for issuance of a default decision with supporting materials by July 20, 2015, addressing Respondent's violations and the appropriate sanctions for the violations. The Default Order also asked the Division to specifically address the issues considered by Securities and Exchange Commission ("SEC" or the "Commission") Administrative Law Judge Cameron Elliot in determining the appropriate sanctions against

David W. Dube, CPA, in the March 5, 2013, Order Making Findings and Imposing Sanctions by Default *In the Matter of Peak Wealth Opportunities, LLC, and David W. Dube, CPA*, Exch. Act Rel. No. 69036, 2013 WL 812635 (Mar. 5, 2013). A copy of the Default Order was sent to Respondent by the Office of the Hearing Officer by FedEx Express to Respondent's UPS Store Address, and was delivered and signed for on June 17, 2015.

On July 20, 2015, the Division filed a Motion for Issuance of a Default Decision ("Default Motion"), together with supporting evidentiary materials, seeking the censure of Respondent, the revocation of Respondent's registration, and the imposition of a civil money penalty of $25,000. To date, Respondent has not filed any response to the Default Motion or otherwise participated in this proceeding.

For the reasons set forth below, the Division's Default Motion is **GRANTED**. Respondent is censured, Respondent's registration with the PCAOB is permanently revoked, and Respondent is ordered to pay a civil money penalty of $10,000.

2. Violations

The factual allegations in the OIP are deemed true pursuant to PCAOB Rule 5409(a). Additionally, a review of the evidentiary materials filed by the Division in support of its Default Motion supports a determination that the OIP's factual allegations are true.[1]

[1] When making findings, the Board should not rely solely on the allegations of the OIP, but should review the evidence submitted by its staff and determine whether the evidence adequately supports the findings requested. *See Paul Gaynes*, PCAOB File No. 105-2011-006 at 2 and 2 n.1 (Initial Decision Nov. 10, 2011; Notice of Finality Jan. 3, 2012). As the SEC noted in approving the imposition of sanctions by the NASD following a default in *James M. Russen, Jr.*, Exch. Act Rel. No. 32895, 51 S.E.C. 675, 678 n.12 (Sept. 14, 1993), "The [NASD] did not base its conclusion simply on the complaint's allegations; rather, it reviewed the record evidence presented by its staff and determined that the evidence supported a finding of violation. This approach affords this Commission a basis for discharging its review function under Section 19 of the Securities Exchange Act."

Respondent is a proprietorship located in Florida, and is licensed to engage in the practice of public accounting by the Florida Department of Business & Professional Regulation. *See* Exhibit E-1 attached to the Declaration of Heather S. Howard ("Howard Decl.") filed July 20, 2015 in support of the Default Motion at PCAOB-DUBE-000006. Respondent became registered with the Board on April 13, 2010, pursuant to Section 102 of the Sarbanes-Oxley Act and Board Rules. *See* Exhibit E-10 to the Howard Decl. at PCAOB-DUBE-000053.

Pursuant to Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2201, each registered public accounting firm is required to submit an annual report to the Board on Form 2 by June 30 of each year. In addition, pursuant to Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202, each registered public accounting firm must pay an annual fee to the Board by July 31 of each year. According to the PCAOB's electronic registration database, Respondent has failed both to file an annual report and to pay an annual fee in 2012, 2013 and 2014.[2] *See* Exhibit E-10 to the Howard Decl. at PCAOB-DUBE-000053.

These facts establish that Respondent violated Sections 102(d) and 102(f) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2202, as alleged in the OIP.

3. Sanctions

As the Division's Default Motion acknowledges, the so-called "*Steadman* factors" should be taken into account in determining whether any sanctions at all are in the public interest, and the factors listed in Section 21B(c) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), provide guidance in considering whether to impose civil money penalties. *See*

[2] The Division includes in its Default Motion evidence that Respondent failed to file its annual report for 2015, due on June 30, 2015. *See* Howard Decl. ¶20; *see* Default Motion at 2 n.4, 13. This allegation was not included in the OIP when the OIP was issued on September 10, 2014, as it had not yet occurred, but may be considered in connection with the imposition of sanctions. *See Davis Accounting Group, P.C.,* PCAOB File No. 105-2009-004 at 15-16 n.20 (Mar. 29, 2011).

Default Motion at 7-9. The *Steadman* factors are "the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The Exchange Act Section 21(B)(c) factors include:

> (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C. and Larry O'Donnell, CPA, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10. The SEC has confirmed that "[a]n analysis based on Section 21B is ... sufficiently flexible to be used in this context." *R.E. Bassie & Co.*, Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

Based on an analysis of these factors, the Division requests that Respondent be censured, that Respondent's registration be permanently revoked and that a civil money penalty of $25,000 be imposed upon Respondent. *See* Default Motion at 1, 14.

A. An Analysis of the *Steadman* Factors Supports Censure and Revocation of Respondent's Registration

The evidentiary materials submitted by the Division in support of the Default Motion establish that, prior to the institution of these proceedings, the PCAOB's Registration Staff and the Division made numerous attempts to notify Respondent of its failure to timely file annual reports or pay annual fees, and gave Respondent multiple opportunities to withdraw from registration without penalty:

1. On September 15, 2011, the PCAOB's Registration Staff sent a letter to Respondent at the address listed in Respondent's registration application ("Registered Address") by Federal Express, reminding Respondent of its failure to pay its 2011 annual fee, and also providing instructions for filing a Form 1-WD to withdraw from PCAOB registration if Respondent no longer wished to be registered. *See* Exhibit E-2 to the Howard Decl. at PCAOB-DUBE-000031-000032. The September 15, 2011 letter was delivered and signed for on September 16, 2011. *Id.* at 000033-000034.
2. On September 6, 2012, the PCAOB's Registration Staff sent a letter to Respondent at the Registered Address by Federal Express, reminding Respondent of its failure to file its 2012 annual report and pay its 2012 annual fee. This letter also provided instructions for filing a Form 1-WD to withdraw from PCAOB registration. *See* Exhibit E-3 to the Howard Decl. at PCAOB-DUBE-000035-000036. The September 6, 2012 letter was delivered and signed for on September 7, 2012. *Id.* at 000037.
3. On October 16, 2012, the PCAOB's Registration Staff sent a "Second Notice" to Respondent at the Registered Address by Federal Express regarding the Firm's delinquency in filing its 2012 annual report and paying its 2012 annual fee. S*ee* Exhibit E-4 to the Howard Decl. at PCAOB-DUBE-000038-000039.
4. On September 5, 2013, the PCAOB's Registration Staff sent a letter to Respondent at the Registered Address by Federal Express, reminding Respondent

of its failure to file its 2013 annual report and pay its 2013 annual fee. This letter also provided instructions for filing a Form 1-WD to withdraw from PCAOB registration. *See* Exhibit E-5 to the Howard Decl. at PCAOB-DUBE-000040-000041. A Federal Express delivery exception receipt indicates that the September 5, 2013 letter to Respondent at the Registered Address was unable to be delivered and was returned to shipper. *Id.* at 000042.

5. On September 25, 2013, the PCAOB's Registration Staff sent an email to Respondent stating, "We are attempting to reach you concerning your firm's failure to file an Annual Report with the PCAOB, and pay the annual fee, but the address we have on file does not appear to be current. Please review the attached correspondence and proceed accordingly. Also if your address or other information (as the contact person for the firm) has changed, please submit a Form 3 as soon as possible to report those changes." *See* Exhibit E-6 to the Howard Decl. at PCAOB-DUBE-000044.
6. On October 31, 2013, the PCAOB's Registration Staff sent a "Second Notice" to Respondent by email regarding the Firm's delinquency in filing its 2013 annual report and paying its 2013 annual fee. *See* Exhibit E-7 to the Howard Decl. at PCAOB-DUBE-000045-000046. The October 31, 2013 letter specifically advised the Respondent that it must either file its delinquent report and pay its delinquent fee or submit a Form 1-WD, and stated that Respondent's failure to act may result in a disciplinary proceeding and sanctions.
7. On May 8, 2014, the Division sent Respondent a charging letter by Federal Express to Respondent's Registered Address concerning Respondent's failure to file its 2013 annual report and pay its 2013 annual fee. The charging letter

described the basis for possible disciplinary proceedings against Respondent as a result of its delinquencies, and offered Respondent three options: become compliant by filing an annual report and paying the annual fee for 2013, submit a Form 1-WD pursuant to Rule 2107 to withdraw from Board registration, or submit a statement of position as to why the Firm should not be charged in a disciplinary proceeding. The May 8, 2014 charging letter also stated that the Division would not recommend that the Board institute disciplinary proceedings if Respondent completed either of the first two options by May 29, 2014. *See* Exhibit E-8 to the Howard Decl. at PCAOB-DUBE-000047-000049. The May 8, 2014 charging letter to Respondent's Registered Address was delivered and signed for on May 12, 2014. *Id.* at 000050-000051.

Citing this evidence, the Division argues that Respondent's conduct was "egregious in light of the actual notice to Respondent of the violations, the multiple warnings regarding the consequences of failure to act, the multiple opportunities to cure the violations or withdraw the Firm's registration, and the Firm's continuing refusal to participate in the Board's processes." Default Motion at 7. The Division also contends, "Respondent's conduct is particularly egregious when considered in the context of Mr. Dube's extensive disciplinary history." *Id.* (footnote omitted).

The Division's effort to characterize Respondent's failure to file its Annual Reports with the PCAOB and failure to pay its Annual Fees to the PCAOB as "egregious" fails. The OIP in this case alleges failures to file Annual Reports and pay Annual fees; the OIP does not allege fraud, deceit or manipulation, the misappropriation of funds from innocent victims, or any of the other types of violative conduct usually characterized as "egregious" in the context of the securities laws. *See Lowry v. SEC*, 340 F. 3d 501, 505 (8th Cir. 2003). Additionally, the fact that

Mr. Dube was previously the subject of Financial Industry Regulatory Authority ("FINRA") and SEC disciplinary sanctions does not make the Respondent's failure to file Annual Reports or pay Annual Fees "egregious."

As the Division observes, Respondent's violations "were plainly recurrent." Default Motion at 7. The Division also argues that Respondent "acted intentionally or recklessly" (*id.* at 7-8), even though the Division notes that the same evidence would also support a conclusion that Respondent's failure to file Annual Reports and pay Annual Fees represented repeated acts of negligence. *Id.* at 6. The Division also notes that, in light of Respondent's default, there have been no assurances against future violations and no recognition by Respondent of its wrongful conduct. *Id.* at 8. Finally, the Division argues that absent revocation of Respondent's registration, there would be a likelihood of future violations. *Id.* at 9.

The Division has submitted ample evidence to establish that Respondent should be censured and that Respondent's registration should be revoked pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act.[3] When Respondent voluntarily registered with the Board, it accepted the responsibility of every registered accounting firm to file annual reports and pay annual fees. Respondent's failure to file an annual report for four consecutive years or pay an annual fee for three consecutive years reflects, at a minimum, repeated instances of negligent conduct, each of which constitutes a violation of the Sarbanes-Oxley Act and the Board's Rules.

The record reflects that PCAOB Registration Staff made repeated attempts to contact and remind Respondent of its delinquencies. Despite receiving notices sent by the Registration Staff

[3] Pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act, to warrant a temporary suspension or permanent revocation of registration, a respondent's conduct must have involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."

and the Division advising Respondent of its options that would have allowed Respondent to avoid disciplinary action, Respondent did not avail itself of these options but elected instead to do nothing.

In light of these facts, the permanent revocation of Respondent's registration and a censure is appropriate. Respondent's violations continued for several years, even after Respondent was given options for curing them. Moreover, Respondent's failure to participate in this proceeding suggests that Respondent may lack the intent or ability to conform to the Board's requirements.

B. An Analysis of the 21B(c) Factors Supports Imposition of a Civil Monetary Penalty of $10,000

Sections 105(c)(4)(D)(ii) and 105(c)(5) of the Sarbanes-Oxley Act specify maximum civil monetary penalty amounts, and these specified amounts are subject to periodic penalty inflation adjustments as published in the Code of Federal Regulations as required by the Debt Collection Improvement Act of 1996. For conduct occurring after March 3, 2009, the Sarbanes-Oxley Act penalty provisions, as adjusted, authorize the Board to impose a civil money penalty of up to $900,000 for a natural person and up to $17,800,000 for other persons if a violation was committed intentionally or knowingly, including recklessly, or included repeated acts of negligent conduct. *See* 17 C.F.R. § 201.1004 Table IV; *Larry O'Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 14. For violations after March 5, 2013, the comparable maximum adjusted amounts are $950,000 for a natural person and $18,925,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V. For violations after March 3, 2009, that do not involve intentional or knowing (including reckless) conduct or repeated instances of negligence, the Board may impose a maximum civil money penalty of $120,000 for a natural person and $2,375,000 for other persons (*see* 17 C.F.R. § 201.1004 Table IV); for violations after March 5, 2013, the comparable maximum adjusted amounts are $130,000 for a natural person and $2,525,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V; *see also Stan Jeong-Ha Lee*, PCAOB No. 105-2012-001, at 21 (May 9, 2013) ("[A] civil money penalty may be imposed without such a finding [of intentional or knowing conduct, including reckless conduct, or multiple acts of negligence], so long as the penalty does not exceed the amount set forth in Section105(c)(4)(D)(i) of the Act, as adjusted").

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has stated that it is "guided by the statutorily prescribed objectives of any exercise of [its] sanctioning authority: the protection of investors and the public interest." *Larry O'Donnell, CPA, P.C.*, at 9 (citations omitted). The Board has also stated that it will consider the factors set forth in Exchange Act Section 21B(c).

In this case, the Division seeks a monetary penalty of $25,000. In support, the Division relies largely on Respondent's prior disciplinary history with the SEC and FINRA, which includes permanent bars imposed by both the SEC and FINRA. *See* Default Motion at 1. The Division also attempts to characterize Respondent's conduct as "intentional ... or reckless." *See id.* at 1-2.

As the Division notes, on November 9, 2010, Mr. Dube consented, without admitting or denying the findings made by FINRA in a Letter of Acceptance, Waiver, and Consent, to a permanent bar from associating with any FINRA member in any capacity in connection with violations of the NASD's and FINRA's Rules that occurred while Mr. Dube was serving as the President and Chief Compliance Officer of Peak Securities Corp., a securities brokerage firm Mr. Dube operated between 2002 and 2009. Exhibit E-13 to the Howard Decl. at PCAOB-DUBE-000074-000083. Mr. Dube also failed to pay two separate FINRA arbitration awards that had been entered against him in July 2010 and September 2010. *See* Exhibit E-15 to the Howard

Decl. at PCAOB-DUBE-000110-000113 and PCAOB-DUBE-000116-000119. On March 5, 2013, SEC Administrative Law Judge Elliot entered an Order Making Findings and Imposing Sanctions by Default against Peak Wealth Opportunities, LLC ("Peak Wealth"), an investment adviser registered with the SEC, and Mr. Dube, ordering Peak Wealth and Mr. Dube to cease and desist from violating the recordkeeping and reporting provisions of the Investment Advisers Act of 1940, as amended, revoking Peak Wealth's registration as an investment adviser, barring Mr. Dube permanently from association with any investment adviser or any other member of the securities industry, and barring Mr. Dube permanently from appearing or practicing before the Commission as an accountant pursuant to SEC Rule 102(e)(1)(iii). *Peak Wealth*, 2013 WL 812635. SEC ALJ Elliot did not impose a civil monetary penalty against Mr. Dube, finding that a monetary penalty was unnecessary to accomplish the Commission's remedial purposes in light of the other sanctions imposed.[4] *Id.*

There is insufficient evidence to support a finding that Respondent's failure to file Annual Reports and to pay Annual Fees was "intentional" or "reckless" as the Division argues, rather than the result of repeated instances of negligence. "[R]ecklessness is a lesser form of intent rather than a greater degree of negligence," and "reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care...." *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977)).

[4] SEC ALJ Elliot concluded that a civil monetary penalty was "entirely unnecessary to deter Respondents, or any other registered investment adviser or accountant, from committing such violations in the future," in light of the revocation of registration, associational bar, and revocation of the privilege of practicing before the Commission as an accountant.

The Division notes that Respondent has been unjustly enriched by the amount of its unpaid fees. Additionally, the Division argues that "Investors and the Board were indirectly harmed here by the lack of access to information about the Respondent that should have been self-reported annually in 2012, 2013, 2014, and 2015." Default Motion at 11. The Division also emphasizes that there is a need to deter not only Respondent but also other registered accounting firms from engaging in similar conduct in order to protect investors and the public interest.

Taking all of the relevant circumstances into consideration, including Respondent's prior disciplinary history, I agree with the Division that a significant civil money penalty should be imposed. However, I do not agree with the Division's view that a $25,000 civil money penalty is necessary to accomplish the Board's remedial goals. $10,000 is the highest penalty amount that has ever been assessed in any of the numerous prior settled and litigated PCAOB proceedings based on a registered firm's failure to file Annual Reports or pay Annual Fees. There is nothing about Respondent's failures to file Annual Reports and pay Annual Fees that would justify a higher penalty amount here. Additionally, in light of the censure and revocation of Respondent's PCAOB registration, as well as the prior SEC order in March 2013 barring Mr. Dube from appearing or practicing before the Commission as an accountant, imposing a penalty amount higher than $10,000, as recommended by the Division, is not necessary for the protection of investors. Finally, a penalty amount higher than $10,000 is unnecessary to deter other registered accounting firms from engaging in similar conduct in the future. Accordingly, I conclude that a $10,000 civil money penalty is appropriate to accomplish the Board's remedial objectives in this proceeding. While this is well below the maximum penalty that could be imposed, it nonetheless reflects the seriousness of the violations.

4. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and Rule 5300(a), that for violating Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200 by failing to file annual reports for 2012, 2013 and 2014, and for violating Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202 by failing to pay an annual fee for 2012, 2013 and 2014, Respondent David W. Dube is censured, and the registration of David W. Dube is permanently revoked. Additionally, Respondent David W. Dube shall pay a civil money penalty in the amount of $10,000.

This Initial Decision will become final in accordance with PCAOB Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision by filing a petition for review in accordance with PCAOB Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

Dated: August 26, 2015

Marc B. Dorfman
Chief Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of *Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab*,

Respondent.

PCAOB File No. 105-2015-008

Notice of Finality of Initial Decision

January 12, 2016

On November 17, 2015, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab ("the Firm") be permanently revoked and that the Firm pay a civil money penalty in the amount of $7,500. Additionally, the Chief Hearing Officer censured the Firm.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final as to Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

January 12, 2016

PCAOB
Public Company Accounting Oversight Board

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In the Matter of Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab,

Respondent.

PCAOB No. 105-2015-008

Hearing Officer – MBD

INITIAL DECISION (DEFAULT)

November 17, 2015

Summary

Respondent was held in default, pursuant to PCAOB Rule 5409(a), for failing to file an Answer in response to the Order Instituting Disciplinary Proceedings ("OIP"). The allegations in the OIP, which are deemed true and are also supported by evidence in the record, establish that Respondent failed to file annual reports for the years 2012, 2013 and 2014, as required by Section 102(d) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rule 2200. For this violation, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a), Respondent is censured, Respondent's registration with the PCAOB is permanently revoked, and Respondent is ordered to pay a civil money penalty in the amount of $7,500.00.

Appearances

Noah A. Berlin, Esq., Washington, D.C., for the Division of Enforcement and Investigations.

No appearance by or on behalf of Respondent Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab.

INITIAL DECISION

1. Factual Background

On June 10, 2015, the Public Company Accounting Oversight Board ("PCAOB" or the "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") against Respondent Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab ("Respondent") pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rule 5200(a)(1). The OIP alleges that Respondent, a partnership located in Copenhagen, Denmark, and registered with the Board since 2007, failed to file annual reports with the Board for the years 2012, 2013, and 2014 in violation of Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200. The OIP directed that proceedings be held to determine whether the allegations were true, to afford Respondent an opportunity to establish any defenses to the allegations, and, if violations were found, to determine what sanctions were appropriate pursuant to Section 105(c)(4) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a). The OIP further directed Respondent to file an Answer to the allegations contained in the OIP "within twenty (20) days after service of this Order," and also provided

> If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against that Respondent upon consideration of the record, including this Order, the allegations of which may be deemed to be true, as provided by PCAOB Rule 5409(a).

On June 22, 2015, the Office of the Secretary of the Board filed a Notice of Service stating that the OIP in this matter was served on Respondent by delivering the document by Federal Express on June 12, 2015 to the address used in Respondent's registration application ("Registered Address"), as evidenced by a confirmation of receipt attached to the Notice of

Service. As the Notice of Service explained in footnote 1, while Denmark is a signatory to the Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters, Nov. 15, 1965, 20 U.S.T. 361, T.I.A.S. No. 6638 (1969) (the "Convention"), Denmark does not object to the method of service provided in Article 10(a) of the Convention. As a result, the Convention would not preclude sending judicial documents through postal channels directly to persons in Denmark pursuant to Article 10(a) of the Convention, and service by Federal Express and other private international couriers is treated as the equivalent of service through postal channels under the Convention. *See Zhang v. Baidu.com Inc.*, 932 F. Supp. 2d 561, 567 (S.D.N.Y. 2013); *Advanced Aerofoil Techs., AG v. Todaro*, 11 Civ. 9505 (ALC) (DCF), 2012 U.S. Dist. LEXIS 12383 at *5 (S.D.N.Y. Jan. 31, 2012). Service of the OIP was accordingly effected in a manner consistent with the Convention.

Based on the foregoing, Respondent received actual notice of this proceeding through lawful service of the OIP.

Respondent failed to file an Answer to the OIP. On July 23, 2015, the Hearing Officer issued an Order directing Respondent to show cause why it should not be deemed to be in default pursuant to PCAOB Rule 5409(a)(2) ("Show Cause Order"). The Show Cause Order directed Respondent to file a response by August 24, 2015, and advised Respondent that if it failed to respond to the Show Cause Order within the time allowed, Respondent may be deemed to be in default, and a default decision may be issued finding that Respondent committed the violations alleged in the OIP and imposing sanctions. A copy of the Show Cause Order was sent to Respondent by the Office of the Hearing Officer by both email to the email address listed in Respondent's registration application ("Email Address") and FedEx International to Respondent's Registered Address. A "read-receipt" message sent to the Hearing Office indicates that Respondent received and read the email attaching the Show Cause Order on July 23, 2015, and a FedEx tracking receipt indicates that the package containing the Show Cause Order was delivered to Respondent on July 27, 2015.

Respondent did not respond to the Show Cause Order. On September 11, 2015, the Hearing Officer issued an Order deeming Respondent to be in default pursuant to PCAOB Rule 5409(a)(2) (the "Default Order"). The Default Order directed the Division of Enforcement and Investigations ("Division") to file a motion for issuance of a default decision with supporting materials by October 21, 2015, addressing Respondent's violations and the appropriate sanctions for the violations. A copy of the Default Order was sent to Respondent by the Office of the Hearing Officer to Respondent's Email Address and to Respondent's Registered Address by FedEx International. A "read-receipt" message sent to the Hearing Office indicates that Respondent received and read the email attaching the Default Order on September 11, 2015, and a FedEx tracking receipt indicates that the package containing the Default Order was delivered to Respondent on September 14, 2015.

On October 20, 2015, the Division filed a Motion for Issuance of a Default Decision ("Default Motion"), together with supporting evidentiary materials, seeking the censure of Respondent, the revocation of Respondent's registration, and the imposition of a civil money penalty of $7,500.00. To date, Respondent has not filed any response to the Default Motion or otherwise participated in this proceeding.

For the reasons set forth below, the Division's Default Motion is **GRANTED**. Respondent is censured, Respondent's registration with the PCAOB is permanently revoked, and Respondent is ordered to pay a civil money penalty of $7,500.00.

2. Violations

The factual allegations in the OIP are deemed true pursuant to PCAOB Rule 5409(a). Additionally, a review of the evidentiary materials filed by the Division in support of its Default Motion supports a determination that the OIP's factual allegations are true.[1]

Respondent is a partnership located in Copenhagen, Denmark, and is licensed to engage in the practice of public accounting by the Danish Commerce and Companies Agency. *See* Exhibit E-1 attached to the Declaration of Heather S. Howard ("Howard Decl.") filed October 20, 2015 in support of the Default Motion at PCAOB-CHRMORTENSEN-0002, 0004. Respondent became registered with the Board on October 16, 2007, pursuant to Section 102 of the Sarbanes-Oxley Act and Board Rules. *See* Exhibit E-17 to the Howard Decl.

Pursuant to Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2201, each registered public accounting firm is required to submit an annual report to the Board on Form 2 by June 30 of each year. According to the PCAOB's electronic registration database, Respondent has failed to file an annual report in 2012, 2013 and 2014.[2] *See* Exhibit E-17 to the Howard Decl. The materials submitted by the Division in support of its Default Motion

[1] When making findings, the Board should not rely solely on the allegations of the OIP, but should review the evidence submitted by its staff and determine whether the evidence adequately supports the findings requested. *See Paul Gaynes*, PCAOB File No. 105-2011-006 at 2 and 2 n.1 (Initial Decision Nov. 10, 2011; Notice of Finality Jan. 3, 2012). As the SEC noted in approving the imposition of sanctions by the NASD following a default in *James M. Russen, Jr.*, Exch. Act Rel. No. 32895, 51 S.E.C. 675, 678 n.12 (Sept. 14, 1993), "The [NASD] did not base its conclusion simply on the complaint's allegations; rather, it reviewed the record evidence presented by its staff and determined that the evidence supported a finding of violation. This approach affords this Commission a basis for discharging its review function under Section 19 of the Securities Exchange Act."

[2] The Division includes in its Default Motion evidence that Respondent failed to file its annual report for 2015, due on June 30, 2015. *See* Howard Decl. ¶20; *see* Default Motion at 2 n.3, 4, 10. This allegation was not included in the OIP when the OIP was issued on June 10, 2015, as it had not yet occurred, but may be considered in connection with the imposition of sanctions. *See Davis Accounting Group, P.C.,* PCAOB File No. 105-2009-004 at 15-16 n.20 (Mar. 29, 2011).

additionally demonstrate that Respondent issued four audit reports for issuer clients over a span of four years while delinquent. *See* Default Motion at 1 and Exhibits E-6, E-9, E-13, and E-16 to the Howard Decl.

These facts establish that Respondent violated Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200, as alleged in the OIP.

3. Sanctions

The remaining issue is what sanctions should be imposed for Respondent's violations. In determining sanctions, the so-called "*Steadman* factors" should be taken into account in determining whether any sanctions at all are in the public interest, and the factors listed in Section 21B(c) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), provide guidance in considering whether to impose civil money penalties. The *Steadman* factors are "the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The Exchange Act Section 21B(c) factors include:

> (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.

> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C. and Larry O'Donnell, CPA, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10. The SEC has confirmed that "[a]n analysis based on Section 21B is ... sufficiently flexible to be used in this context." *R.E. Bassie & Co.*, Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

The Division requests that Respondent be censured, that Respondent's registration be permanently revoked and that a civil money penalty of $7,500.00 be imposed upon Respondent. *See* Default Motion at 1, 3, 10.

A. An Analysis of the *Steadman* Factors Supports Censure and Revocation of Respondent's Registration

The materials submitted by the Division in support of its Default Motion establish that, prior to the institution of these proceedings, both staff from the PCAOB's Division of Registration and Inspections ("Registration Staff") and the Division made numerous attempts to notify Respondent of its failure to file annual reports and gave Respondent multiple opportunities to withdraw from PCAOB registration without penalty, and that each time Respondent failed to respond while continuing to issue audit reports for issuer clients:

1. On September 6, 2012, Registration Staff sent a letter to Respondent at Respondent's Registered Address by FedEx International, concerning Respondent's failure to timely file its annual report for 2012, and also providing instructions for filing a Form 1-WD to withdraw from PCAOB registration if Respondent no longer wished to be registered. *See* Exhibit E-5 to the Howard Decl. at PCAOB-CHRMORTENSEN-0026-0027. The September 6, 2012 letter was delivered and signed for on September 10, 2012. *Id.* at 0028.

2. On or about September 28, 2012, Respondent issued an audit report for issuer client Advanced Oxygen Technologies, Inc., filed with the Securities and Exchange Commission ("Commission") on October 1, 2012. *See* Exhibit E-6 to the Howard Decl.

3. On October 16, 2012, Registration Staff sent a "Second Notice" to Respondent at the Registered Address by FedEx International, reminding Respondent of its failure to timely file its 2012 annual report. This letter also provided instructions for filing a Form 1-WD to withdraw from PCAOB registration. The letter warned Respondent that:

   > The failure to act may result in the referral of this matter to the PCAOB Division of Enforcement and Investigations for further action, including a potential disciplinary proceeding recommendation to the Board. Board disciplinary proceedings may result in significant sanctions, including civil money penalties and the revocation of a public accounting firm's registration with the Board.

   See Exhibit E-7 to the Howard Decl. at PCAOB-CHRMORTENSEN-0029-0030. The October 16, 2012 letter was delivered and signed for on October 18, 2012. *Id.* at 0031.

4. On September 9, 2013, Registration Staff sent a letter to Respondent at an alternate address by FedEx International, reminding Respondent of its failure to timely file its 2013 annual report. This letter also provided instructions for filing a Form 1-WD to withdraw from PCAOB registration. *See* Exhibit E-8 to the Howard Decl. at PCAOB-CHRMORTENSEN-0033-0034. The September 9, 2013 letter was delivered and signed for on September 11, 2013. *Id.* at 0035.

5. On or about September 28, 2013, Respondent issued an audit report for issuer client Advanced Oxygen Technologies, Inc., filed with the Commission on October 10, 2013. *See* Exhibit E-9 to the Howard Decl.

6. On September 5, 2014, Registration Staff sent a letter to Respondent at the Registered Address by FedEx International, reminding Respondent of its failure to timely file its 2014 annual report. This letter also provided instructions for filing a Form 1-WD to withdraw from PCAOB registration. *See* Exhibit E-11 to the Howard Decl. at PCAOB-CHRMORTENSEN-0038-0039. The September 5, 2014 letter was delivered and signed for on September 8, 2014. *Id.* at 0040.

7. On or about October 1, 2014, Respondent issued an audit report for issuer client Advanced Oxygen Technologies, Inc., filed with the Commission on October 3, 2014. *See* Exhibit E-13 to the Howard Decl.

8. On October 17, 2014, Registration Staff sent a "Second Notice" to Respondent at the Registered Address by FedEx International, reminding Respondent of its failure to timely file its 2014 annual report. This letter also provided instructions for filing a Form 1-WD to withdraw from PCAOB registration, and warned Respondent that:

> The failure to act may result in the referral of this matter to the PCAOB Division of Enforcement and Investigations for further action, including a potential disciplinary proceeding recommendation to the Board. The Board has permanently revoked the registration of, and ordered civil money penalties against, firms that failed to file annual reports and pay annual fees.

See Exhibit E-12 to the Howard Decl. at PCAOB-CHRMORTENSEN-0042-0043. The October 17, 2014 letter was delivered and signed for on October 20, 2014. *Id.* at 0044.

9. On February 2, 2015, the Division sent Respondent a charging letter ("Charging Letter") by FedEx International to Respondent's Registered Address concerning Respondent's failure to timely file its 2014 annual report. The Charging Letter described the basis for possible disciplinary proceedings against Respondent as a result of its delinquencies, and offered Respondent three options: become compliant by filing an annual report for 2014, submit a Form 1-WD pursuant to PCAOB Rule 2107 to withdraw from Board registration, or submit a statement of position as to why the [Respondent] should not be charged in a disciplinary proceeding. The Charging Letter also stated that the Division would not recommend that the Board institute disciplinary proceedings if Respondent completed either of the first two options by February 23, 2015. *See* Exhibit E-14 to the Howard Decl. at PCAOB-CHRMORTENSEN-0128-0130. The Charging Letter was delivered and signed for on February 9, 2015. *Id.* at 0132.

10. The Board instituted this disciplinary proceeding on June 10, 2015.

11. Despite service of the OIP, Respondent has failed to file an Answer, and despite delivery of the Show Cause Order and the Default Order by both email and FedEx International courier service, Respondent has failed to participate in this proceeding.

12. On or about October 1, 2015, Respondent issued an audit report for issuer client Advanced Oxygen Technologies, Inc., filed with the Commission on September 29, 2015. *See* Exhibit E-16 to the Howard Decl.

13. As of the date of the Division's October 20, 2015 Default Motion, Respondent has not filed its annual reports for the years 2012, 2013, 2014, or 2015, and has

not filed a Form 1-WD to withdraw from PCAOB registration.

The Division has submitted ample evidence to establish that Respondent should be censured and that Respondent's registration should be suspended or revoked pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act.[3] When Respondent voluntarily registered with the Board, it accepted the responsibility of every registered accounting firm to file annual reports. Respondent's failure to file an annual report for four consecutive years reflects, at a minimum, repeated instances of negligent conduct, each of which constitutes a violation of the Sarbanes-Oxley Act and the Board's Rules.

The record also establishes that PCAOB Registration Staff made repeated attempts to contact and remind Respondent of its delinquencies, and repeatedly warned about the consequences of failure to take action. Respondent could have taken action in response to the Division's Charging Letter to avoid these proceedings by simply filing a Form 1-WD (or by filing its Annual Reports), but despite receiving notices sent by the Registration Staff and the Division advising Respondent of its options that would have allowed Respondent to avoid disciplinary action, Respondent did not avail itself of these options and elected instead to do nothing, while also continuing to issue audit reports for issuer clients.

In light of these facts, a censure and the permanent revocation of Respondent's registration are appropriate. Respondent's violations continued for several years, even after Respondent was given options for curing them. Moreover, Respondent's failure to participate in

[3] Pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act, to warrant a temporary suspension or permanent revocation of registration, a respondent's conduct must have involved "intentional or knowing conduct, including reckless conduct," or "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."

this proceeding suggests that Respondent may lack the intent or ability to conform to the Board's requirements.

B. An Analysis of the 21B(c) Factors Supports Imposition of a Civil Monetary Penalty of $7,500.00

Sections 105(c)(4)(D)(ii) and 105(c)(5) of the Sarbanes-Oxley Act specify maximum civil monetary penalty amounts, and these specified amounts are subject to periodic penalty inflation adjustments as published in the Code of Federal Regulations as required by the Debt Collection Improvement Act of 1996. For conduct occurring after March 3, 2009, the Sarbanes-Oxley Act penalty provisions, as adjusted, authorize the Board to impose a civil money penalty of up to $900,000 for a natural person and up to $17,800,000 for other persons if a violation was committed intentionally or knowingly, including recklessly, or included repeated acts of negligent conduct. *See* 17 C.F.R. § 201.1004 Table IV; *Larry O'Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 14. For violations after March 5, 2013, the comparable maximum adjusted amounts are $950,000 for a natural person and $18,925,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V. For violations after March 3, 2009, that do not involve intentional or knowing (including reckless) conduct or repeated instances of negligence, the Board may impose a maximum civil money penalty of $120,000 for a natural person and $2,375,000 for other persons (*see* 17 C.F.R. § 201.1004 Table IV); for violations after March 5, 2013, the comparable maximum adjusted amounts are $130,000 for a natural person and $2,525,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V; *see also Stan Jeong-Ha Lee*, PCAOB No. 105-2012-001, at 21 (May 9, 2013) ("[A] civil money penalty may be imposed without such a finding [of intentional or knowing conduct, including reckless conduct, or multiple acts of negligence], so long as the penalty does not exceed the amount set forth in Section105(c)(4)(D)(i) of the Act, as adjusted").

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has stated that it is "guided by the statutorily prescribed objectives of any exercise of [its] sanctioning authority: the protection of investors and the public interest." *Larry O'Donnell, CPA, P.C.*, at 9 (citations omitted). The Board has also stated that it will consider the factors set forth in Exchange Act Section 21B(c).

In this case, the Division seeks a monetary penalty of $7,500.00. In support, the Division cites several of the factors listed in *O'Donnell*. First, the Division states that Respondent's repeated failures to adhere to Section 102(d) of the Act and PCAOB Rule 2200 show deliberate or reckless disregard for these regulatory requirements, particularly given its failure to comply for several years and its issuance of four audit reports during the period of delinquency. *See* Default Motion at 6. Second, the Division argues that "Investors and the Board were indirectly harmed here by the lack of access to information about the Respondent that it should have self-reported annually in 2012, 2013, 2014, and 2015." Default Motion at 7. Third, the Division notes that Respondent has been unjustly enriched through the potential opportunities and reputational benefits of being a PCAOB registrant, including continuing to issue audit reports, without complying with the Board's annual reporting requirements. *Id.* at 8. Finally, the Division emphasizes that there is a need to deter not only Respondent but also other registered accounting firms from engaging in similar conduct in order to protect investors and the public interest. *Id.*

Taking all of the relevant circumstances into consideration, I agree with the Division that a civil money penalty of $7,500.00 should be imposed. Respondent was repeatedly warned of its failure to timely file its annual reports and was given several opportunities to cure its deficiencies. Despite these repeated warnings, Respondent elected to do nothing while continuing to issue audit reports for issuer clients. Respondent's conduct involved repeated instances of at least negligent disregard of its obligations as a registered accounting firm for an extended period of time.[4] Finally, there is a need to deter not only Respondent but also other registered accounting firms from engaging in similar conduct in order to protect investors and the public interest.

Taking all of the relevant circumstances into consideration, I conclude that the $7,500.00 civil money penalty sought by the Division is appropriate to accomplish the Board's remedial objectives in this proceeding. While this is well below the maximum penalty that could be imposed, it nonetheless reflects the seriousness of the violations to deter other registered accounting firms from engaging in similar conduct in the future.

4. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and Rule 5300(a), that for violating Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200 by failing to file annual reports for 2012, 2013 and 2014 as charged in the OIP, and for failing to file an annual report for 2015 for purposes of assessing sanctions, Respondent Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab is censured, the registration of Respondent Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab is permanently revoked, and Respondent Chr. Mortensen-Revisionsfirma, statsautoriseret revisionsinteressentskab shall pay a

[4] There is insufficient evidence to conclude that Respondent's conduct was "intentional" or "reckless," as opposed to negligent. "[R]ecklessness is a lesser form of intent rather than a greater degree of negligence," and "reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care…." *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977)).

civil money penalty in the amount of $7,500.00.

This Initial Decision will become final in accordance with PCAOB Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision by filing a petition for review in accordance with PCAOB Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

Dated: November 17, 2015

Marc B. Dorfman
Chief Hearing Officer

PCAOB
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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Monte C. Waldman CPA,

Respondent.

PCAOB File No. 105-2015-013

Notice of Finality of Initial Decision

August 4, 2016

On June 10, 2016, the Chief Hearing Officer of the Public Company Accounting Oversight Board issued the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that the PCAOB registration of Monte C. Waldman CPA ("the Firm") be revoked, with a right to reapply after one year from the date the Initial Decision becomes final, that the Firm be censured, and that the Firm pay a civil money penalty in the amount of $2,500.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final as to the Firm pursuant to PCAOB Rule 5204(d).

The Firm shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Monte C. Waldman CPA as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If the Firm does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against the Firm on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an

application for Commission review or the expiration of the time period for the Commission to order review. If the Firm files an application for review by the Commission or the Commission orders review of sanctions ordered against the Firm, the effective date of the sanctions ordered against the Firm shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Secretary

August 4, 2016

PCAOB
Public Company Accounting Oversight Board

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Washington, DC 20006
Telephone: (202) 207-9100
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In the Matter of Monte C. Waldman CPA,

Respondent.

PCAOB No. 105-2015-013

Hearing Officer – MBD

INITIAL DECISION (SUMMARY DISPOSITION)

June 10, 2016

Summary

This Initial Decision grants the Division of Enforcement and Investigations' motion for summary disposition in accordance with PCAOB Rule 5427. The undisputed evidence establishes that Respondent, a registered public accounting firm, failed to timely file annual reports and to timely pay annual fees for the years 2014 and 2015, as required by Sections 102(d) and 102(f) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rules 2201 and 2202. Additionally, Respondent's annual reports for the years 2014 and 2015, as ultimately filed after the initiation of this proceeding, were inaccurate and misleading in violation of PCAOB Rule 2200. For these violations, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a), this Initial Decision censures Respondent, revokes Respondent's registration with the PCAOB (with a right to reapply after one year from the date this Initial Decision becomes final), and orders Respondent to pay a civil money penalty of $2,500.

Appearances

Noah A. Berlin, Esq., Washington, D.C., for the PCAOB Division of Enforcement and Investigations.

Mr. Monte Waldman on behalf of Respondent Monte C. Waldman, CPA.

INITIAL DECISION

1. Factual Background

On June 10, 2015, the Public Company Accounting Oversight Board ("PCAOB" or the "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002, as amended, 15 U.S.C. § 7201 et seq. ("Sarbanes-Oxley Act"), and PCAOB Rule 5200(a)(1), alleging that Respondent Monte C. Waldman, CPA ("Waldman" or "Respondent"), a proprietorship located in Miami, Florida and registered with the Board since 2012, failed to file an annual report with the Board for the year 2014 in violation of Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200, and failed to pay an annual fee to the Board for the year 2014 in violation of Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202. The OIP directed that proceedings be held to determine whether the allegations were true, to afford Waldman an opportunity to establish any defenses to the allegations, and, if violations were found, to determine what sanctions were appropriate pursuant to Section 105(c)(4) of the Sarbanes-Oxley Act and PCAOB Rule 5300(a). The OIP further directed Waldman to file an Answer to the allegations contained in the OIP "within twenty (20) days after service of this Order," and also provided

> If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against that Respondent upon consideration of the record, including this Order, the allegations of which may be deemed to be true, as provided by PCAOB Rule 5409(a).

On August 12, 2015, the Office of the Secretary of the Board ("Secretary") filed a Notice of Service stating that the OIP was served on June 16, 2015.

Waldman failed to file an Answer to the OIP. On August 14, 2015, the Hearing Officer issued an Order directing Respondent to show cause why it should not be deemed to be in default pursuant to PCAOB Rule 5409(a)(2) ("Show Cause Order"). The Show Cause Order directed Respondent to file a response by September 16, 2015, and advised Respondent that if it failed to respond to the Show Cause Order within the time allowed, Respondent may be deemed to be in default, and a default decision may be issued finding that Respondent committed the violations alleged in the OIP and imposing sanctions.

On August 15, 2015, Waldman responded to the Show Cause Order by email to the Hearing Office stating, "Please be advised I've been paying the fees. I think my balance is $250. The [B]oard told me I was still on board. Please respond at your earliest [c]onvenience." Following receipt of Waldman's email, on August 17, 2015, the Hearing Office's Case Administrator sent an email to Waldman suggesting that Waldman "contact Division attorney Noah Berlin for any questions you may have regarding disposition of this proceeding," to which Waldman replied "Ok, I will appreciate that, but would rather not bother him about. I decided to keep paying the fees incurred, and stay with the PCAOB program. I use the association for a few clients, and been careful with issuing ver[y] few reports in past."

On September 1, 2015, counsel for the Division of Enforcement and Investigations ("Division") filed a motion requesting that a prehearing conference be held in this proceeding "in in light of Respondent's post-OIP actions, which may be deemed to be Respondent's answer to the OIP's allegations." On September 8, 2015, the Hearing Officer issued an order vacating the Show Cause Order and scheduling an initial prehearing conference for September 25, 2015.

On September 25, 2015, an Initial Prehearing Conference ("Initial Conference") was held by telephone conference call. At the Initial Conference, the parties discussed with the Hearing

Officer whether Waldman was delinquent in filing annual reports or paying annual fees as alleged in the OIP, whether any alleged delinquencies had been or would be cured, and whether it was likely that the parties could agree to a resolution of this matter. Based on those discussions, the Hearing Officer scheduled a Status Conference to be held by telephone with the parties for November 3, 2015, which would also serve as a pre-motion conference pursuant to PCAOB Rule 5427(c) for both the Division to file a motion for summary disposition regarding any alleged violations and proposed sanctions and for Waldman to file a motion for summary disposition seeking to dismiss the OIP.

On November 3, 2015, a Status Conference was held by telephone conference call. At the Status Conference, counsel for the Division confirmed that several months after the filing of the OIP, Waldman filed its 2014 and 2015 annual reports and paid its 2014 and 2015 annual fees. Counsel for the Division also stated that while Waldman may have filed its annual reports and paid its annual fees, the Division believed that Waldman had not timely complied with its obligations under the Sarbanes-Oxley Act and the PCAOB's Rules prior to service of the OIP. Counsel for the Division also stated that the Division believed that Waldman's annual reports for both 2014 and 2015 were inaccurate in violation of PCAOB Rule 2200. The Hearing Officer directed the Division to advise the Hearing Office by November 10, 2015, whether the Division wished to continue to proceed to a resolution of this matter under the OIP as issued on June 10, 2015, or whether the Division wished to seek the Board's authorization to amend the OIP to include new matters of fact or law.

By letter dated November 3, 2015, and received by the Hearing Office on November 9, 2015, Waldman stated that as of November 3 it was "in full compliance with PCAOB Rules 2200 and 2202 regarding the payment of annual fees and filing the annual report..." and requested that this proceeding be dismissed. A copy of Waldman's November 3, 2015 letter was also sent to counsel for the Division.

On November 10, 2015, the Division filed a motion to stay this proceeding, including all deadlines, until February 10, 2016, or such earlier date as an amended OIP was served, stating that the Division intended to file a motion with the Board pursuant to PCAOB Rule 5201(d)(1) seeking an amendment to the OIP "to include new matters of fact and/or law that are outside the scope of the original OIP, including initiating new charges against Waldman for conduct that occurred after the filing of the OIP."

On November 12, 2015, the Hearing Officer issued an order staying this proceeding until December 30, 2015, and directing the Division to promptly file its motion to amend the OIP with the Board and to notify the Hearing Office of the results of the Board's consideration of the Division's motion to amend the OIP.

On December 16, 2015, the Board issued an Amended OIP alleging that Waldman failed to timely file its 2014 and 2015 annual reports in violation of PCAOB Rule 2201, failed to timely pay its 2014 and 2015 annual fees in violation of PCAOB Rule 2202, and that Waldman's 2014 and 2015 annual reports as filed were inaccurate, confusing, and contradictory, in violation of PCAOB Rule 2200. On December 22, 2015, the Secretary filed a Notice of Service stating that the Amended OIP was served on Waldman on December 17, 2015.

By letter to the Secretary dated December 23, 2015, Waldman denied the allegations contained in the Amended OIP and reiterated Waldman's request that this proceeding be dismissed. A copy of Waldman's December 23, 2015 letter was also sent to counsel for the Division.

On December 23, 2015, the Hearing Officer issued an order scheduling a prehearing conference for January 22, 2016, and directing the parties to confer and attempt to agree upon a proposed schedule for the completion of this proceeding.

On January 12, 2016, the parties filed a Joint Proposed Schedule indicating that the parties had agreed that this proceeding could be resolved through the summary disposition process without the need for a hearing or testimony of live witnesses. The parties proposed deadlines of February 26, 2016, for the Division to file its motion for summary disposition and March 18, 2016, for Waldman to file a response. On January 13, 2016, the Hearing Officer issued an order adopting the parties' Joint Proposed Schedule and cancelling the prehearing conference scheduled for January 22, 2016.

On February 26, 2016, the Division filed a Motion for Summary Disposition (the "Division's Motion"), together with supporting evidentiary materials, seeking the censure of Waldman, the revocation of Waldman's registration (with a right to reapply after at least one year), and the imposition of a civil money penalty of at least $2,500.

On February 29, 2016, the Division filed a motion to supplement the record to include three emails that the Division had received from Waldman. On March 8, 2016, the Division filed a second motion to supplement the record to include the Annual Report on Form 10-K for an issuer for which Waldman had issued an audit report in October 2015. Waldman did not file a response to either of the Division's motions to supplement the record. Accordingly, the Division's motions to supplement the record are **GRANTED**.

Waldman's response to the Division's Motion was due on March 18, 2016. To date, Waldman has not filed any response to the Division's Motion.

For the reasons set forth below, the Division's Motion is **GRANTED**. Waldman is censured, Waldman's registration with the PCAOB is revoked (with a right to reapply after one year from the date this Initial Decision becomes final), and Waldman is ordered to pay a civil money penalty of $2,500.

2. Applicable Standard for Summary Disposition

PCAOB Rule 5427(d) provides that summary disposition is appropriate in Board disciplinary proceedings "if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a disposition as a matter of law." As both the Board and the SEC have explained, Rule 5427, in substance, parallels Rule 56 of the Federal Rules of Civil Procedure, under which the ultimate question is whether the record as a whole demonstrates the existence of any factual disputes that must be resolved through a hearing. *See Gately & Assocs.*, Exch. Act Rel. No. 62656 (Aug. 5, 2010), 99 SEC Docket 31023; PCAOB File No. 105-2008-001 (June 4, 2009).

A party seeking summary disposition must make a preliminary showing that no genuine issue of material fact exists. The burden then shifts to the nonmovant. To avoid summary disposition, the nonmovant "must contradict the showing by pointing to specific facts demonstrating that there is, indeed, a trialworthy issue." *Gately* at *20*, citing Nat'l Amusements, Inc. v. Town of Dedham*, 43 F.3d 731, 735 (1st Cir. 1995). In determining whether there is a genuine dispute as to a material fact, the record "'should be viewed most favorably to the non-moving party,' but the hearing officer 'need not credit purely conclusory allegations, indulge in rank speculation, or draw improbable inferences.'" *Id.*

Here the parties agreed that this matter should be resolved using the summary disposition process. Additionally, the Division's Motion is unopposed. While Waldman had previously submitted a letter denying that it committed the violations alleged in the Amended OIP and asking that this proceeding be dismissed, Waldman's "purely conclusory" statements are not sufficient to create a genuine issue of material fact. *See Gately* at *20.

The findings and conclusions in this Initial Decision are based on the record. Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 97-104 (1981).

3. Violations

The evidentiary materials submitted by the Division in support of the Division's Motion establish that there is no genuine issue of material fact that Waldman violated Sections 102(d) and 102(f) of the Sarbanes-Oxley Act and PCAOB Rules 2201 and 2202 by failing to timely file annual reports and timely pay annual fees, as alleged in the Amended OIP:

a) Waldman is a proprietorship located in Florida, and is licensed to engage in the practice of public accounting by the Florida Board of Accountancy. *See* Exhibit E-1 attached to the Declaration of Marques Q. Jenkins ("Jenkins Decl.") filed February 26, 2016, in support of the Division's Motion at PCAOB-WALDMAN-0006. Waldman became registered with the Board on June 12, 2012, pursuant to Section 102 of the Sarbanes-Oxley Act and Board Rules. *See* Exhibit E-6 to the Jenkins Decl. at PCAOB-WALDMAN-0043.

b) Pursuant to Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rules 2200 and 2201, each registered public accounting firm is required to submit an annual report to the Board on Form 2 by June 30 of each year. In addition, pursuant to Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202, each registered public accounting firm must pay an annual fee to the Board by July 31 of any year in which the firm is required to file an annual report.

c) According to the PCAOB's electronic registration database, Waldman failed to timely file an annual report in 2014 and 2015. *See* Exhibit E-13 to the Jenkins Decl. at PCAOB-WALDMAN-0086 and Exhibit E-14 to the Jenkins Decl. at PCAOB-WALDMAN-0107.

d) Waldman failed to timely pay an annual fee in 2014 and 2015. *See* Exhibit E-7 to the Jenkins Decl. at PCAOB-WALDMAN-0043a and Exhibit E-8 to the Jenkins Decl. at PCAOB-WALDMAN-0043b.

e) The Board instituted these proceedings on June 10, 2015.

f) On September 11, 2015, Waldman paid the remaining $250 of its 2014 annual fee. *See* Exhibit E-8 to the Jenkins Decl. at PCAOB-WALDMAN-0043b.

g) Waldman filed its 2015 Form 2 annual report for reporting period April 1, 2014 to March 31, 2015, on September 11, 2015. *See* Exhibit E-14 to the Jenkins Decl. at PCAOB-WALDMAN-0088-0108.

h) Waldman paid its 2015 annual fee on September 25, 2015. *See* Exhibit E-8 to the Jenkins Decl. at PCAOB-WALDMAN-0043b.

i) Waldman filed its 2014 Form 2 annual report for reporting period April 1, 2013 to March 31, 2014, on September 25, 2015. *See* Exhibit E-13 to the Jenkins Decl. at PCAOB-WALDMAN-0071-0087.

The materials submitted by the Division also establish that there is no genuine issue of material fact that Waldman filed annual reports for the 2014 and 2015 reporting periods that were inaccurate, misleading, or contradictory in violation of PCAOB Rule 2200, as alleged in the Amended OIP:

j) The Form 2 annual report Waldman filed for reporting period April 1, 2013 to March 31, 2014 ("2014 Form 2"), includes one company, Seamless Technologies, Inc. ("Seamless Technologies"), as an "issuer" under Item 4.1, "AUDIT REPORTS ISSUED BY THE FIRM." *See* Exhibit E-13 to the Jenkins Decl. at PCAOB-WALDMAN-0076.

k) The Form 2 annual report Waldman filed for reporting period April 1, 2014 to March 31, 2015 ("2015 Form 2"), includes four companies as "issuers" under Item 4.1, "AUDIT REPORTS ISSUED BY THE FIRM": Seamless Technologies, Tao Minerals Ltd. ("Tao Minerals"), Amazonas Florestal Ltd. ("Amazonas"), and The Movie Studio, Inc. ("Movie Studio"). *See* Exhibit E-14 to the Jenkins Decl. at PCAOB-WALDMAN-0094.

l) Seamless Technologies was not an issuer during the 2014 or 2015 reporting periods as it was not required to file reports under Section 15(d) of the Securities Exchange Act of 1934 ("Exchange Act"), and had not registered its common stock under Section 12 of the Exchange Act.

Seamless Technologies was acquired in July 2013 by Avnet, Inc. *See* Avnet, Inc., Annual Report on Form 10-K for the fiscal year ending June 27, 2015 at 23, available at: https://www.sec.gov/Archives/edgar/data/8858/000155837015001540/avt-20150627x10k.htm.

m) The audit report dated January 31, 2012, for Tao Minerals listed in Item 4.1(a)(3) of Waldman's 2015 Form 2 does not fall within the reporting period. Additionally, while Tao Minerals was an issuer during the 2015 reporting period, the SEC revoked the registration of Tao Minerals' securities for failure to timely file required periodic reports on May 13, 2015, as Tao Minerals last filed a Quarterly Report on Form 10-Q for the period ended October 31, 2011, and did not file year-end financial statements for the fiscal year ended January 31, 2012. *See In the Matter of Revonergy Inc., Siberian Energy Group Inc., Tao Minerals Ltd. (N/K/A Canam Gold Corp.), and Todays Alternative Energy Corp.*, Exch. Act Rel. No. 74943 (May 13, 2015).

n) Movie Studio was not an issuer during the 2014 or 2015 reporting periods as it no longer met the definition of an issuer after filing a Form 15 to deregister its common stock as of February 12, 2012. *See* Movie Studio (f/k/a/ Destination Television) Form 15-12G (dated Feb. 12, 2010, filed Feb. 12, 2012), available at: https://www.sec.gov/Archives/edgar/data/1109067/000116768710000003/dstvform15.htm. Movie Studio did voluntarily file an Annual Report on

Form 10-K for the fiscal year ended October 31, 2014 with the SEC, including an audit report by Terry L. Johnson CPA, a former PCAOB registrant who recently was permanently barred by the SEC from appearing or practicing before the SEC.[1] *See* Movie Studio Annual Report on Form 10-K for the fiscal year ended October 31, 2014, available at: https://www.sec.gov/Archives/edgar/data/1109067/000157093115000009/mves_10-koct2014iiv1.htm; Exch. Act Rel. No. 75944, *In the Matter of Terry L. Johnson, CPA* (Sept. 17, 2015).

o) Amazonas was not an issuer during the 2015 reporting period as it was not required to file reports under Section 15(d) of the Exchange Act, and had not registered its common stock under Section 12 of the Exchange Act. Amazonas is a subsidiary of Peartrack Security Systems, Inc., which has reported that as of December 31, 2015, Amazonas was in default of an agreement pursuant to which Amazonas was to register its shares with the SEC by January 31, 2013. *See* Peartrack Security Systems, Inc., Annual Report on Form 10-K for the fiscal year ended December 31, 2015, available at: https://www.sec.gov/Archives/edgar/data/1379245/000137924516000039/f20151231ptss10kfinalclean.htm.

[1] Waldman's 2014 Form 2 stated in Item 4.2, "AUDIT REPORTS WITH RESPECT TO WHICH THE FIRM PLAYED A SUBSTANTIAL ROLE DURING THE REPORTING PERIOD," that Waldman played a substantial role in the preparation of audit reports dated October 31, 2012, 2013 and 2014 for Movie Studio that were issued by Terry Johnson CPA and Patrick Rogers CPA. *See* Exhibit E-13 to the Jenkins Decl. at PCAOB-WALDMAN-0077. Waldman's filings do not explain the discrepancy between what Waldman's 2014 Form 2 states in Item 4.2 with respect to Movie Studio as opposed to what Waldman's 2015 Form 2 states in Item 4.1.

p) On December 23, 2015, Waldman submitted a letter to the Secretary, copying Division counsel, in which he requested dismissal of the proceeding, and asserted, among other things, that he had "filed the form 2 as accurately as possible," and that "there was nothing reported inaccurately or confusing in my annual reports."

q) On January 20, 2016, Waldman filed a Form 2/A amending Waldman's 2015 Form 2. Waldman indicated in the Form 2/A that the 2015 Form 2 was amended to indicate, in Item 3.1, that Waldman did not audit issuers, but Waldman did not amend the 2015 Form 2's Item 4.1 list of four "issuers" for whom Waldman purported to issue audit reports. Investors reviewing Waldman's filings would have a difficult time determining whether Waldman had, or had not, conducted issuer audits subject to Board oversight during the 2015 reporting period.

r) As noted by the Division in its March 8, 2016 motion to supplement the record, Waldman has apparently conducted at least one issuer audit during the 2016 reporting period. *See* Summit Networks Inc., Annual Report on Form 10-K for the fiscal year ended July 31, 2015, attached as Exh. A to the Division's March 8, 2016 motion to supplement the record, at p. 33 of 52.

It is self-evident that the distinction between "issuer" audits and audits of companies who are not "issuers" is significant to investors as well as to issuers and auditors. Issuer audits are subject to Board inspection and oversight, but audits of non-issuers are not. *See* PCAOB Rule

2100(i)(iii); Board Registration FAQ, PCAOB Release 2003-011E (Feb. 4, 2015) at 5 ("....[R]egistration alone, however, does not subject a firm's audits to Board oversight. The Board's standard-setting, inspections, and enforcement authority, relate only to a firm's practice in connection with audits of issuers, brokers, or dealers.").

The Division has also submitted evidence that Mr. Waldman was disciplined on May 11, 2015, by the Florida Board of Accountancy for failing to return client documents and information to a client, failing to file that client's tax returns for three consecutive years, and offering accounting services through an unlicensed CPA firm known as "Monte C. Waldman, CPA." *See* Exhibit E-18 to the Jenkins Decl. at PCAOB-WALDMAN-0152-0163 (Final Order of the Dept. of Business and Professional Regulation, State of Florida Board of Accountancy, Case No. 2013-040119, License No. AC44382 (May 7, 2015)). Pursuant to a settlement, the Florida Board of Accountancy ordered that Mr. Waldman be reprimanded and pay a fine of $500 and costs totaling $1,252.32. *Id.*

4. Sanctions

As the Division's Motion acknowledges, the so-called "*Steadman* factors" should be taken into account in determining whether any sanctions at all are in the public interest, and the factors listed in Section 21B(c) of the Exchange Act provide guidance in considering whether to impose civil money penalties. *See* Division's Motion at 7-10. The *Steadman* factors are "the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." *Steadman v. SEC*, 603

F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The Exchange Act Section 21(B)(c) factors include:

> (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is assessed has previously been found by the Commission, another appropriate regulatory agency, or self-regulatory organization ("SRO") to have violated federal securities laws, state securities laws, or SRO rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter such person and other persons from such conduct; and (6) such other matters as justice may require.
>
> Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but sets them out as factors to be considered.

Larry O'Donnell, CPA, P.C. and Larry O'Donnell, CPA, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 9-10. The SEC has confirmed that "[a]n analysis based on Section 21B is ... sufficiently flexible to be used in this context." *R.E. Bassie & Co.*, Accounting and Auditing Enforcement Rel. No. 3354, 2012 SEC LEXIS 89 at *47 (Jan. 10, 2012).

Based on an analysis of these factors, the Division requests that Waldman be censured, that Waldman's registration be revoked (with the right to reapply after at least one year), and that a civil money penalty of at least $2,500 be imposed upon Waldman. *See* Division's Motion at 1, 3, and 7.

A. An Analysis of the *Steadman* Factors Supports Censure and Revocation of Waldman's Registration (with a Right to Reapply After One Year)

The Division has submitted ample evidence to establish that Waldman should be censured and that Waldman's registration should be revoked, with a right to reapply after one year, pursuant to Sections 105(c)(4)(A) and 105(c)(5) of the Sarbanes-Oxley Act. The undisputed facts demonstrate that Waldman violated Rules 2201 and 2202 for the 2014 and 2015 reporting periods. Waldman filed its 2014 annual report on September 25, 2015—more than a year after it was due. Waldman filed its 2015 annual report nearly three months after it was due. Waldman did not file either report until after the Board instituted these disciplinary proceedings.

Similarly, Waldman did not pay its 2014 annual fee in full until September 11, 2015, more than a year after it was due. Waldman did not pay its 2015 annual fee until September 25, 2015, nearly two months after it was due. Additionally, Waldman did not pay its 2014 or 2015 annual fees until after the Board instituted these disciplinary proceedings.

When Waldman voluntarily registered with the Board, it accepted the responsibility of every registered accounting firm to file annual reports and pay annual fees, and to do so by the required deadlines, without the need for the Board to initiate disciplinary proceedings. Waldman's failure to file an annual report by the required deadline and to timely pay an annual fee for two consecutive years reflects, at a minimum, repeated instances of negligent conduct, each of which constitutes a violation of the Sarbanes-Oxley Act and the Board's Rules. The record also reflects that the 2014 and 2015 annual reports Waldman finally did file with the Board contained misleading and inaccurate representations suggesting falsely that Waldman had audited a number of issuers at various times when Waldman had not in fact done so.

Waldman's communications with the Hearing Office, the Division and the Secretary since these proceedings were initiated also indicate that Waldman does not accept any responsibility for its failure to file accurate and timely annual reports and pay its annual fees on time and, indeed, does not recognize that it has done anything wrong. Additionally, Waldman has not provided the Board with adequate assurances that it will comply with the Sarbanes-Oxley Act and the Board's Rules in the future.

In light of these facts, a censure and the revocation of Waldman's registration, with a right to reapply after one year, are appropriate.

B. An Analysis of the Exchange Act Section 21B(c) Factors Supports Imposition of a Civil Monetary Penalty of $2,500

Sections 105(c)(4)(D)(ii) and 105(c)(5) of the Sarbanes-Oxley Act specify maximum civil monetary penalty amounts, and these specified amounts are subject to periodic penalty inflation adjustments as published in the Code of Federal Regulations as required by the Debt Collection Improvement Act of 1996. For conduct occurring after March 3, 2009, the Sarbanes-Oxley Act penalty provisions, as adjusted, authorize the Board to impose a civil money penalty of up to $900,000 for a natural person and up to $17,800,000 for other persons if a violation was committed intentionally or knowingly, including recklessly, or included repeated acts of negligent conduct. *See* 17 C.F.R. § 201.1004 Table IV; *Larry O'Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 (Oct. 19, 2010), at 14. For violations after March 5, 2013, the comparable maximum adjusted amounts are $950,000 for a natural person and $18,925,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V. For violations after March 3, 2009, that do not involve intentional or knowing (including reckless) conduct or repeated instances of negligence, the Board may impose a maximum civil money penalty of $120,000 for a natural person and $2,375,000 for other persons (*see* 17 C.F.R. § 201.1004 Table IV); for violations after March 5, 2013, the comparable maximum adjusted amounts are $130,000 for a natural person and $2,525,000 for other persons. *See* 17 C.F.R. § 201.1005 Table V; *see also Stan Jeong-Ha Lee*, PCAOB No. 105-2012-001, at 21 (May 9, 2013) ("[A] civil money penalty may be imposed without such a finding [of intentional or knowing conduct, including reckless conduct, or multiple acts of negligence], so long as the penalty does not exceed the amount set forth in Section105(c)(4)(D)(i) of the Act, as adjusted").

In determining whether a civil money penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has stated that it is "guided by the statutorily prescribed objectives of any exercise of [its] sanctioning authority: the protection of investors and the public interest." *Larry O'Donnell, CPA, P.C.*, at 9 (citations omitted). The Board has also stated that it will consider the factors set forth in Exchange Act Section 21B(c).

In this case, the Division seeks a monetary penalty of $2,500. In support, the Division argues that the proposed sanction is consistent with prior delinquent filer litigation but also recognizes that "each matter presents unique facts and [the Division] has, to date, eschewed a formulaic approach to determining the sanctions it seeks in delinquent filer matters." Division's Motion at 15-16.

Taking all of the relevant circumstances into consideration, including the prior disciplinary history of Mr. Waldman in the State of Florida, the $2,500 civil money penalty sought by the Division is appropriate to accomplish the Board's remedial objectives in this proceeding. While this is well below the maximum penalty that could be imposed, it nonetheless reflects the seriousness of the violations and will send a sufficiently strong message to Waldman and to other firms of the importance of complying with the Board's Rules.

5. Record Certification

Pursuant to Rule 5202(d), I certify that the record includes the items set forth in the Index to the Record issued by the Secretary and served on the parties on May 9, 2016.

6. Order

For the foregoing reasons, **IT IS ORDERED**, pursuant to Sections 105(c)(4) and 105(c)(5) of the Sarbanes-Oxley Act and Rule 5300(a), that for violating Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200 by failing to timely file annual reports for 2014 and

2015, for violating Section 102(f) of the Sarbanes-Oxley Act and PCAOB Rule 2202 by failing to timely pay annual fees for 2014 and 2015, and for violating PCAOB Rule 2200 by filing misleading or inaccurate annual reports for 2014 and 2015, Respondent Monte C. Waldman, CPA is censured, and the registration of Respondent Monte C. Waldman, CPA is revoked with the right to reapply after one (1) year from the date that this Initial Decision becomes final. Additionally, Respondent Monte C. Waldman, CPA shall pay a civil money penalty in the amount of $2,500.

This Initial Decision will become final in accordance with PCAOB Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision by filing a petition for review in accordance with PCAOB Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

Dated: June 10, 2016

Marc B. Dorfman
Chief Hearing Officer

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Gale Moore, CPA,

Respondent

PCAOB File No. 105-2012-004

FINAL DECISION

August 23, 2016

Appearances

Raphael J. Larson, Esq., and Bernard A. McDonough, Esq., Washington, DC, for the Division of Enforcement and Investigations

Gale Moore, CPA, pro se

I.

Respondent Gale Moore seeks Board review of the hearing officer's initial decision in this disciplinary proceeding. Moore is charged with violating PCAOB rules and auditing standards in a 2007 audit of an issuer's financial statements. In leading that audit, she allegedly failed to exercise due professional care, including professional skepticism, failed to obtain and evaluate sufficient audit evidence, and failed to adequately supervise assistants, among other charges, in two high-risk audit areas: (1) the issuer's recognition of revenue from four transactions, the first of their kind for the company, with two newly created and thinly capitalized special purpose entities, together accounting for about 44% of the issuer's 2007 reported revenue; and (2) the issuer's reduction of its year-end 2007 estimate of future losses on multi-year service contracts, based on a changed assumption, not supported by any change in contractual commitment, that a certain contract would be expanded and become profitable for its last seven years. The issuer later restated its financial statements for 2007 and the prior year and disclosed that it had incorrectly recognized revenue from the four transactions and had under-accrued its contract loss reserve. The restatement reduced the issuer's reported 2007 revenue by $9.1 million (49%) and increased its reported 2007 net loss by $3 million (20%).

The initial decision described Moore's work on the 2007 Basin Water audit as "profoundly flawed" and concluded, "[I]t is abundantly clear that Moore violated applicable PCAOB Rules and professional standards, and her departure from those standards was extreme." The decision discussed what, in the hearing officer's view, were multiple warning signs that should have caused Moore to apply greater scrutiny in the audit. These included management's aggressive accounting approach, in Moore's judgment; the novelty, timing, and size of the four transactions; the structuring of those transactions to book revenue with little or no real economic benefit to the issuer; the issuer's failure to collect the first payments due under the agreements; and management's previous attempts to rely on what Moore concluded were insufficiently supported assumptions to estimate contract loss reserves. The decision found that, despite "the many red flags," and despite Moore's role as a specialist and trainer of other auditors in the particular accounting interpretation that should have informed her analysis of the four SPE transactions, she "failed to meet the most basic standards for professional conduct and the performance of an audit" as a result of her "unquestioning and virtually complete reliance on management's representations, her failure to obtain independent support for her conclusions, and her failure to investigate numerous inconsistencies and gaps in the audit evidence." Concluding that Moore's violations were repeated and "created a significant risk of harm to public investors and to the financial markets," the decision ordered that Moore be censured; that she be barred from associating with a registered public accounting firm (with the proviso that she be permitted to petition the Board to associate with such a firm after two years); that she be limited in her activities for an additional two years from serving as an engagement or concurring partner; and that she complete 50 hours of professional education.

Moore argues on appeal that she conducted the audit in a professional manner, that the issuer's management may have intentionally withheld information from the auditors, that documentation in the 2007 audit file was lost, and that the sanctions ordered are unwarranted. After *de novo* review of the record, in light of the arguments presented to us, we conclude that the violations found were proven by a preponderance of the evidence and we determine appropriate sanctions, in substantial agreement with the initial decision.

II.

On October 23, 2012, the Board issued an Order Instituting Disciplinary Proceedings (OIP) alleging violations of PCAOB rules and auditing standards by Gale Moore, CPA, in auditing the 2007 financial statements of Basin Water, Inc. It is undisputed in this proceeding that at all relevant times Basin Water was an issuer, as defined by Section 2(a)(7) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(7), and PCAOB rules, and that Moore was a person associated with SingerLewak LLP, a registered public accounting firm, as defined by Section 2(a)(9) of the Act, 15 U.S.C.

7201(9), and PCAOB rules. Moore filed her answer to the OIP on November 19, 2012. Following three days of hearings in July 2013, the hearing officer issued an initial decision on July 16, 2014. Moore petitioned for Board review of the initial decision, and, on November 28, 2014, briefing concluded. Neither party requested oral argument.

III.

The facts of this case are mostly uncontested, furnished to a large extent by admissions in Moore's answer, joint stipulations between Moore and the Division of Enforcement and Investigations, and Moore's hearing testimony.[1/]

A. Moore Was the Auditor With Final Responsibility for the 2007 Audit of a Water Treatment Company That Moore Understood Had an Aggressive Approach to Recognizing Revenue and Estimating Future Contract Losses.

Moore was the auditor with final responsibility, or engagement partner, for SingerLewak's audit of the financial statements of Basin Water, Inc., for the year ending December 31, 2007. R.D. 34d & 43, Joint Stipulations (Jt. Stip.) 2 ¶¶ 8, 9; *see, e.g.*, AU §§ 230.06, 311.02.[2/] Moore testified that, as such, she was the individual with final responsibility for the conduct of the audit and, on March 17, 2008, authorized the issuance of SingerLewak's audit report expressing an unqualified opinion on Basin Water's 2007 financial statements. Tr. 20-21; *see* R.D. 49a, Hearing Exhibit (Ex.) D-43 at 73. She also acknowledged that, in her role as engagement partner, she was responsible for obtaining reasonable assurance regarding whether the company's financial statements were presented in accordance with United States generally accepted accounting principles (GAAP); for planning, conducting, and reporting the

[1/] After Moore filed her answer, she dismissed her counsel and since then has represented herself in this proceeding. Index to the Record on Review, Record Document (R.D.) 58, Initial Decision (I.D.) 7. We note that the initial decision stated, "The Hearing Officer is satisfied that Moore understood both the process for entering into joint stipulations and the significance of the content of the stipulations…[and also] that Moore understood the conduct of the hearing and how to present evidence in her favor…. In addition, she filed briefs (pre-hearing, post-hearing, and supplemental) that reflected a sound understanding of the issues." I.D. 7 n.24, 8 n.25.

All transcript (Tr.) citations in this opinion are to Moore's hearing testimony (R.D. 45a and 46a), unless otherwise noted.

[2/] References in this opinion to PCAOB rules and auditing standards are to those that were in effect at the time of the audit.

results of the audit in accordance with PCAOB auditing standards; for determining if the objectives of the audit were accomplished, which involved reviewing and evaluating the work of other members of the engagement team to see whether the results of the work performed were consistent with the audit opinion; and for determining whether the audit procedures performed were sufficient to support the audit opinion she developed. Tr. 21-26; *see, e.g.*, AU §§ 110, 311, 326.

Moore had been a Certified Public Accountant since 1996. Tr. 16. After working for one of the largest national audit firms from 1997 to 2004, Moore joined SingerLewak as a partner in January 2005 in its Irvine, California office. Tr. 15-16. SingerLewak designated Moore a specialist in revenue recognition and the consolidation of financial statements, and specifically in the application of the Financial Accounting Standards Board (FASB) interpretation designated FIN 46(R), which addresses whether the financial statements of a related entity must be consolidated with (and, among other things, its revenue from other consolidated entities netted against) the financial statements of the reporting company. Tr. 16-18; R.D. 13, Answer (Ans.) 8 ¶ 11. As a designated specialist, Moore trained other auditors at SingerLewak on the application of FIN 46(R). Tr. 320-21. She was assisted on the audit of Basin Water's 2007 financial statements by a senior manager, two "in-charges," and two staff accountants. Ex. J-5 at 3. All audit procedures were performed at Basin Water's California headquarters. Ex. J-5 at 2. Moore was actively involved in the audit. See R.D. 47b at 488 (senior manager on audit team agreeing with Moore that during the audit, Moore was "always available to the team on any sort of accounting issues as they arose," that she "often supplement[ed] research for the team," and was "often part of the management discussions.").

Basin Water was a Delaware corporation, headquartered in California, that designed, assembled, and serviced systems for treating contaminated groundwater for utilities, cities, municipalities, and other customers. Ex. D-43 at 5, 43. It operated as a privately held company from 1999 until May 2006, when it completed its initial public offering. Ex. D-43 at 5-6. In 2007, it traded on the Nasdaq Global Market. For the year ended December 31, 2007, it reported revenues of approximately $18.8 million, which was later restated to $9.7 million, discussed below. Jt. Stip. 1 ¶ 2, 8 ¶ 27.

Moore helped bring Basin Water to SingerLewak as a client in the fall of 2005 and proceeded to audit its financial statements back to 2002. Thus, she was familiar with the company and its accounting practices. In its Form 10-K for the year ended 2007, filed with the SEC on March 17, 2008, Basin Water reported that it prepared its financial statements in conformity with GAAP. Ex. D-43 at 47. Historically, as Moore knew, Basin Water derived most of its revenue from selling and leasing its systems to end users. Ex. D-43 at 5; Jt. Stip. 2 ¶ 11.b. Whether Basin Water sold or leased its systems could significantly affect the timing of its revenue recognition. If the customer leased the product, Basin Water recognized the revenue ratably over the life of the lease, typically five or more years. Ex. D-43 at 45; Jt. Stip. 2 ¶ 11.d. But if the customer purchased the system, Basin Water recognized the entire sales price as revenue within one to two quarters. Jt. Stip. 2 ¶ 11.c.

In 2007, Basin Water changed its business model to include selling already leased (or to be leased) treatment systems to two newly created special purpose entities (SPEs). Jt. Stip. 2 ¶ 11.e. Moore understood that management's goal in doing so was to accelerate revenue recognition. Ans. 5-6 ¶ 6; Tr. 64, 120. Basin Water management stated that it determined to recognize revenue from sales of water treatment systems to these SPEs in accordance with the provisions of SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*, which sets forth certain criteria for the recognition of revenue from a sale. Exs. J-1; D-15. In its 2007 financial statements, Basin Water recognized approximately $8.3 million in revenue—44% of its reported total 2007 revenue of $18.8 million—from the SPE transactions. Jt. Stip. 3 ¶ 11.m. Moore has not contested that, as the initial decision found (I.D. 63-64), the SPE transactions, collectively and individually, were material to Basin Water's 2007 financial statements. *See, e.g.*, Jt. Stip. 3 ¶ 11.q; *see also, e.g.*, AU §§ 110.02, 326.13, 326.25.

Furthermore, Basin Water management conveyed to Moore in an accounting memorandum prepared for a different transaction in 2007 that it applied FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* as revised in December 2003 (FIN 46(R)), to its determinations of whether Basin Water was required to consolidate into its financial statements those of the other entity involved in the transaction. *See* Ex. GM-1 at 2. The effect of a determination that consolidation is required under FIN 46(R) would be that revenue, even if it otherwise meets the criteria for recognition under SAB 104, may nevertheless have to be eliminated through consolidation of the company's and the variable interest entity's (i.e., the SPE's) financial statements. This would be the case if the SPE were determined to be a variable interest entity and if Basin Water was determined to be the "primary beneficiary" of the SPE. Basin Water's financial statements were not consolidated with those of the SPEs, with the result that the $8.3 million in revenue from the four SPE transactions appeared on Basin Water's financial statements and was not eliminated. Revenue recognized from the transactions thus contributed positively to the company's total 2007 revenues of $18.8 million and permitted it to avoid reporting a year-over-year loss compared to its total 2006 revenues of $17.1 million. Jt. Stip. 3 ¶ 11.m.

In addition to sales and leases of water treatment systems, Basin Water also generated revenue from service contracts under which it maintained the water treatment systems it sold and leased. Ex. D-43 at 45-46. There is no dispute that, during 2007, certain of Basin Water's service contracts operated at net cash flow losses. Moore understood that, under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, Basin Water was required to record a reserve for all probable and reasonably estimable losses related to its contracts. Ans. 31 ¶ 67. Moore also understood that in the prior year, when Basin Water was preparing its first financial statements as a public company, management had built into its estimate some assumptions it had made about a current contract that were not supported by enforceable contract terms, or, as Moore described it, "built a lot of unenforceable assumptions into their reserve," which management revisited after discussions with SingerLewak. Tr. 343. In its 2007 financial statements, Basin Water recorded a reserve on its balance sheet for contract losses of approximately $7.3 million at December 31, 2007. Ex. D-43 at 46, 109; Jt. Stip. 7 ¶ 18.b. In calculating this reserve, management determined to eliminate the reserve that it had established in 2006 for the final seven years of a particular water district contract that had lost $179,052 in 2007 and was projected to lose $195,433 in 2008. Jt. Stip. 7 ¶¶ 18.f, 19, 20. Management assumed operations of the district's well could be expanded in the future and that the contract would become profitable after 2008 (Jt. Stip. 7 ¶ 20), and pursuant to this change in assumption, reduced its total loss reserve by $1.8 million. The amount of this reduction alone was more than two times the planning materiality threshold approved by Moore for the 2007 Basin Water audit. Jt. Stip. 3 ¶ 11.q.

In February 2008, in response to shareholder suits filed in late 2007 and early 2008 challenging Basin Water's accounting for its contract loss reserves, Basin Water's audit committee retained independent counsel to conduct an inquiry into the allegations and ultimately directed counsel to broaden the investigation to include the company's revenue recognition practices, including the 2007 SPE transactions. Jt. Stip. 8 ¶ 25. That investigation ultimately led to the company restating its 2006 and 2007 financial statements in February 2009, based on its incorrect recognition of $8.3 million in revenue for the four SPE transactions and under-accruing its contract loss reserve by $1.8 million. Ex. D-16, D-17; D-39; D-46 at 4, 5, 6 & 103.

B. Planning for the 2007 Basin Water Audit Identified a High Risk of Material Misstatement with Respect to Revenue Recognition and the Contract Loss Reserve.

In leading the planning of the 2007 Basin Water audit, Moore assessed the overall audit risk as "high." Ex. J-8 at 4. Moore admits in her appeal briefing that she was "acutely aware of the risks posed by the revenue transactions and contract loss estimates." R.D. 61, Moore Opening Brief (MB) 4. Moore understood Basin Water was a "young company" that was still "developing internal controls" (Tr. 266), so she did not rely on those controls in the audit. The work papers documenting the risk assessment noted that "the company's business strategy has changed significantly during 2007" and that Basin Water management's "operating style is more aggressive than before." Ex. J-8 at 2. Those work papers also identified management's accounting with respect to revenue recognition in particular as "aggressive." Specifically, the work papers stated, "Revenue recognition in the past has been aggres[s]ive" (Ex. J-6 at 2) and "[t]he Company has entered into and contemplated new sales structures that require more analysis to ensure that revenue recognition criteria has been met. Therefore, [SingerLewak] believes that there could be a risk of material misstatement due to error on revenue and its related accounts" (Ex. J-7 at 3). Further, the engagement team noted that it had "discussed and agreed that the significant audit risks come from the revenue related accounts, such as revenue, accounts receivable and reserve, unbilled receivable and reserve, notes receivable, deferred revenue, and contract loss reserve due to management aggres[s]ive revenue recognition approach and subjective estimates on reserve." Ex. J-7 at 3.

At the hearing, Moore further explained her concerns in audit planning, stating, "Management, throughout the course of Basin's life, had recorded sales—structured sales in very many different ways and, often, sought to recognize revenue without fully researching the accounting implications. And so we were always concerned about revenue recognition." Tr. 134. An example Moore gave of Basin Water's aggressive accounting approach was a certain transaction with a financial institution in 2006. At that time, management proposed to treat the transaction as a sale, which would have allowed it to recognize revenue immediately, but, according to Moore, "the audit team raised questions regarding continuing involvement and, ultimately, management determined that a sales leaseback accounting"—in which the transaction is treated not as a sale but as a form of financing—"was [the] appropriate accounting." Tr. 134.

In May 2007, prior to the planning of the 2007 audit, management discussed with Moore its plan to change Basin Water's business model to include selling already leased (or to be leased) treatment systems to newly created SPEs. Tr. 63-64; Jt. Stip. 2 ¶ 11.e. Management told her it was structuring the transactions so Basin Water could recognize future lease revenue at the time of the transaction and avoid consolidation of its financial statements with those of the SPEs. Tr. 64, 120; Ans. 5-6 ¶ 6. She testified that management told her Basin Water would seek to collect a 50% to 70% down payment for these sales. She pointed out to management that the transactions must have economic substance, that is, as she understood it, the transactions had to transfer risks and rewards from Basin Water to the SPE. Tr. 64-65. Moore led the engagement team in reviewing management's accounting for these four novel transactions in quarterly reviews of Basin Water's financial information during the course of 2007 and relied upon that work in conducting the 2007 audit. Jt. Stip. 4 ¶ 11.z.

As noted above, Moore also concluded that management's contract loss reserve posed a "significant audit risk." Ex. J-7 at 3. Moore identified the contract loss reserve as presenting "a risk of material misstatement because the reserve was based on management's subjective estimate and, as a result, could be insufficient or incomplete." Jt. Stip. 7 ¶ 18.e. Moore knew at the time of the 2007 audit that Basin Water had been sued in three separate shareholder suits from December 27, 2007, to January 31, 2008, for allegedly not adequately accounting for its contract loss reserve. Jt. Stip. 8 ¶ 24. And, as noted, she knew that management in the prior year revised its estimate to eliminate contractually unenforceable assumptions. Tr. 343. To address the risk presented by the contract loss reserve, Moore planned to assign more experienced staff and increase supervision of the staff assigned to this audit area. Jt. Stip. 7 ¶ 18.e.

C. Moore Ultimately Accepted Basin Water Management's Accounting for Four 2007 End-of-Quarter or End-of-Year SPE Transactions Despite Her Understanding That Their Purpose Was To Accelerate Revenue Recognition and Her Concern That They Lacked Economic Substance.

1. Moore Understood That the SPE Transactions Needed To Be Evaluated Both To Determine Whether Revenue Could Be Recognized and Whether the Financial Statements of Basin Water Needed To Be Consolidated With Those of the SPEs.

Basin Water entered into four transactions during 2007 with two SPEs that had the planned effect of accelerating revenue recognition. Ex. J-1; Tr. 64, 120. These four transactions were structured in a similar fashion. As illustrated below, each transaction featured an SPE that would secure funding from a financial institution. The SPE would use that funding to pay Basin Water a down payment to buy a water treatment system. The balance of the sales price would be financed by Basin Water over several years and recorded as a note receivable on Basin Water's books. The SPE would make the payments due to Basin Water using the proceeds it received from the lease payments made by the end user of the treatment system, but not until the cash flow from the leased system reimbursed the SPE for the amount of its down payment to Basin Water. Tr. 422 (R.D. 46b, Division's expert); Jt. Stip. 3-6 ¶¶ 11.s, .t, .gg, 15, 17.[3/]

Thus, as Moore understood, the practical effect of the transactions was to permit Basin Water to recognize a sizeable down payment as immediate revenue and then

[3/] Unbeknownst to Moore at the time of the 2007 audit, the reason for this grace period for the SPE to begin making installment payments is that the funding it received for the down payment was in the form of a loan—not equity—from the third-party financial institution. The grace period permitted the SPE to repay the loan (using end-user lease payments that Basin Water assigned to it) before it had to begin making payments to Basin Water. As explained below, Basin Water management told Moore the down payments were funded by infusions of equity, and she inquired no further. She learned during the restatement audit that this was not true, and that the SPEs in fact had "no meaningful capital infusion into the SPEs, other than the loan[s] from the Financial Institution[s]." Ex. D-17 at 2, n.2.

wait years to recoup the same amount of money it would have collected anyway from the system's lessee under the terms of the underlying lease. *See* Exs. J-1 at 1-2; D-1 at 1-2; D-14 at 3; D-15 at 1-2; D-33 at 2-3; Jt. Stip. 3-5 ¶¶ 11.t, .gg; Tr. 71-75. She testified she was concerned about whether the transactions had economic substance. Tr. 64-65. During the hearing, the senior manager agreed with Moore when she asked him whether the engagement team recognized during initial discussions with management about the SPE transactions that the overall economics of the transactions "weren't entirely different" from the company's standard leasing model, and that in "some instances…actually would be detrimental" to Basin Water. R.D. 47b at 484-85.

VL Capital, LLC (VLC) was an SPE formed on June 29, 2007. Jt. Stip. 2 ¶ 11.f. Basin Water entered into two transactions with VLC during 2007: one on June 28, 2007 (VLC I) and another on December 31, 2007 (VLC II). Jt. Stip. 3 ¶ 11.h. Water Services Solutions, LLC (WSS) was an SPE formed on September 27, 2007. Jt. Stip. 3 ¶ 11.i. Basin Water entered into two transactions with WSS during 2007: one on September 24, 2007 (WSS I) and another on December 26, 2007 (WSS II). Jt. Stip. 3 ¶ 11.k.[4/]

Moore understood that the SPEs were created specifically to enter into transactions with Basin Water. Jt. Stip. 2-3 ¶¶ 11.f-k. She knew that both SPEs were headquartered in Dallas, Texas, and that both SPEs had as their sole principal and managing member a Texas-based attorney. Jt. Stip. 2-3 ¶¶ 11.f, .j, .l.

[4/] These dates suggest that VLC and WSS entered into their first transactions with Basin Water before the SPEs formally existed, but there is no indication in the work papers that Moore considered this discrepancy.

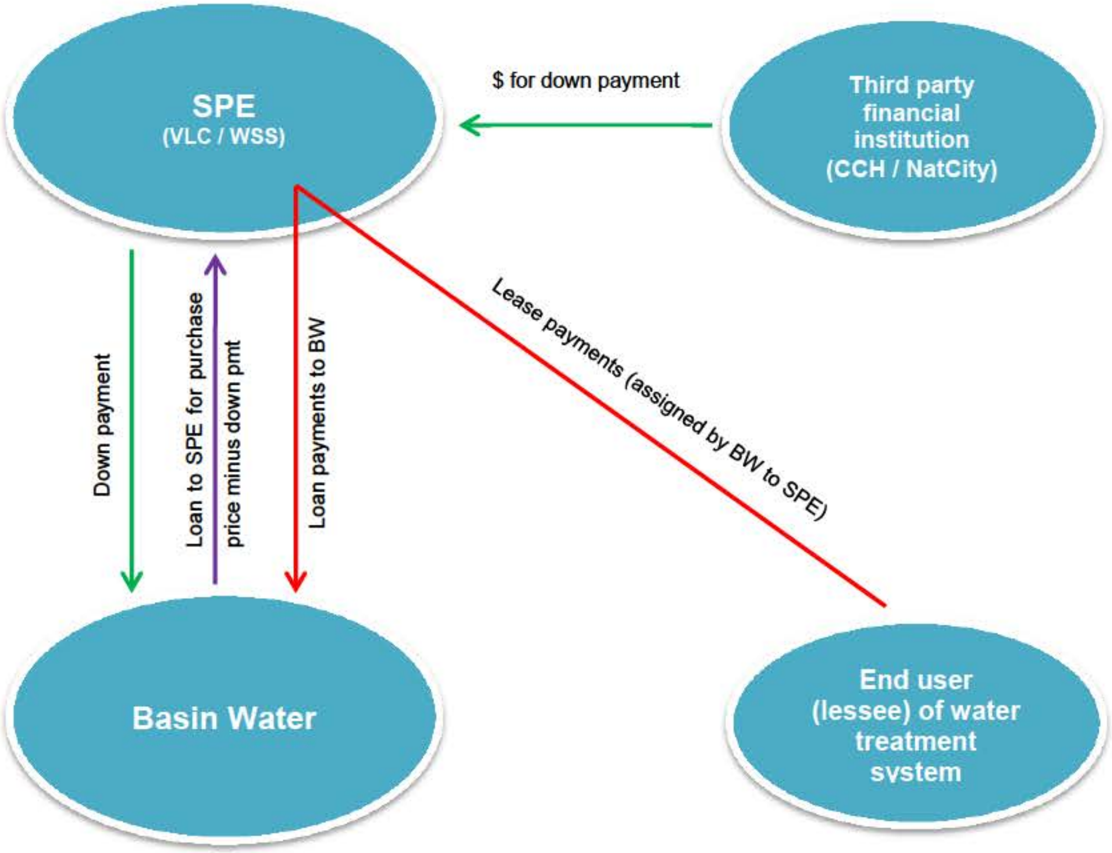
SPE
(VLC / WSS)
$ for down payment
Third party financial institution (CCH / NatCity)
Down payment
Loan to SPE for purchase price minus down pmt
Loan payments to BW
Lease payments (assigned by BW to SPE)
Basin Water
End user (lessee) of water treatment system

Figure adapted from Ex. D-17 at 4.

Basin Water management applied SAB 104 to determine whether it could recognize revenue from the SPE transactions in its financial statements. Exs. J-1; D-15. According to SAB 104, revenue is generally earned and realizable when all of the following criteria are met:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or services have been rendered;
- The seller's price to the buyer is fixed or determinable; and
- Collectibility is reasonably assured.

As discussed below, management concluded that all four criteria for revenue recognition under SAB 104 for the SPE transactions were met. Even if a company can satisfy itself that revenue can be recognized under SAB 104, however, the analysis does not necessarily end there. As Moore noted in the materials she used to train others on the proper accounting for transactions with SPEs, "Enron's collapse exposed a number of worrisome accounting issues," including the use of SPEs to "report illusory gains." Ex. D-36 at 2.[5] FIN 46(R) was issued in January 2003 and amended in December 2003 to "improve financial reporting" by companies involved with such entities with which the company has a "controlling financial interest," termed "variable interest entities" (VIEs). FIN 46(R)-3. The effect of applying FIN 46 (R) is that revenue, even if the revenue otherwise meets the standards for recognition under SAB 104, may nevertheless have to be eliminated through consolidation of the company's and the SPE's financial statements if the company has a controlling financial interest in the SPE. FIN 46(R) addresses arrangements where a controlling financial interest is established through means other than a majority voting interest, and is instead identified by application of a "risk and rewards" model. Under this model, a party that "absorbs a majority of the [SPE's] expected losses, receives a majority of its expected residual returns, or both," must consolidate the SPE in its financial statements. Under this model, as Moore understood, an entity is a VIE if, by design, one or more of the following characteristics exist:

> a. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders. An equity investment at risk of less than 10 percent of the entity's total assets is presumptively insufficient unless the equity investment can be demonstrated to be sufficient.
>
> b. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:
>
> > i. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights;
> >
> > ii. The obligation to absorb the expected losses of the entity; or
> >
> > iii. The right to receive the expected residual returns of the entity.

[5] *See* U.S. Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (July 30, 2003) at 91; Christopher L. Culp, "Credit Risk Management Lessons from Enron," *in Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations* (Chrstopher L. Culp et al., eds., 2003) at 211 ("As of June 1999, Enron had disclosed $34 billion in assets on its balance sheet, but another $51 billion in assets—many of which were troubled or impaired—lay hidden in Enron's unconsolidated special purpose entities (SPEs)."

> c. The equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

FIN 46(R) ¶ 5; Ex. D-36 at 4-5.

Therefore, as Moore put it, a FIN 46(R) analysis includes an examination of the level of control the investors have over the SPE's activities (Ex. D-36 at 5) and whether the SPE is "thinly capitalized" (Ex. D-36 at 4). If an entity is determined to be a VIE by satisfying one of the criteria above, the risks and rewards associated with the VIE must be analyzed to determine who is the "primary beneficiary." The party that is exposed to the majority of the entity's risks and rewards is the primary beneficiary and must consolidate the entity's financial statements with its own.[6/]

Importantly, as Moore explained in her training slides, a FIN 46(R) analysis is not a one-time event, because "[c]hanges in the entity's capital structure and/or its activities or assets can affect this analysis." Ex. D-36 at 7, 14-15; *see* FIN 46(R) ¶ 15. Thus, an unconsolidated entity in one period could become a consolidated entity in another. Ex. D-36 at 7 ("When these events [i.e., changes in the entity's capital structure and/or its activities or assets] occur, the primary beneficiary determination may also change."); *see* FIN 46(R) ¶ 15.

2. Moore Accepted Management's Conclusion That Recognition of Revenue for the VLC I Transaction Was Appropriate.

Moore reviewed the first SPE transaction (VLC I), entered into by Basin Water and VLC at the end of the second quarter of 2007, as part of the procedures performed for that quarter's review, and relied upon those procedures during the annual audit. Jt. Stip. 4 ¶ 11.z; Tr. 36. Moore had determined that the VLC I transaction (as with all the SPE transactions) was an unusual transaction that required greater attention and presented a risk that revenue might be improperly recognized during 2007. The SPE transactions were included in the section of the audit work papers identifying risks of material misstatement. Ex. J-7 at 3; *see* Jt. Stip. 3 ¶ 11.n; Tr. 43-47.

Moore was familiar with SAB 104 and understood that if a transaction did not meet the criteria in SAB 104, generally revenue could not be recognized. Tr. 88. Basin

[6/] Although not addressed in this case, under FIN 46(R), a company that holds "significant variable interests in a variable interest entity but is not the primary beneficiary" still has certain disclosure obligations in its financial reporting, even though it does not consolidate the VIE's financial statements with its own. *See* FIN 46(R) ¶ 24.

Water management concluded that the VLC I transaction met all four criteria in SAB 104 and therefore that it was appropriate to recognize revenue from the transaction. Ex. J-1 at 2-7; Jt. Stip. 4 ¶ 11.w.

According to a letter agreement between Basin Water and VLC that outlined the terms of the transaction, VLC promised to pay Basin Water a total of $5 million for the purchase of certain water treatment systems (less the estimated value of insurance costs and property taxes related to the equipment). Ex. D-1. VLC would make an initial down payment of $500,000 at the closing on June 30, 2007—not a 50%–70% down payment such as had been discussed in Moore's May meeting with Basin Water management—and, beginning after eight months, would make a total of 72 monthly payments of $62,500 each to Basin Water representing the balance due, which would be funded by lease payments made by end users of the water treatment systems. *Id.*; Ex. J-1 at 1-2; Jt. Stip. 3-4 ¶ 11.t. Basin Water management used this letter agreement in preparing a memorandum, dated August 8, 2007, analyzing the VLC I transaction and supporting management's accounting for the transaction. Jt. Stip. 4 ¶ 11.y; Ex. J-1. In that memorandum, management concluded that the VLC I transaction met the criteria necessary for revenue recognition under SAB 104. Ex. J-1 at 2-7; Jt. Stip. 4 ¶ 11.w. Based on the purchase commitment in the letter agreement, Basin Water recognized $3.8 million in revenue for the quarter. Ex. D-44 at 14, 17; Jt. Stip. 3-4 ¶¶ 11.s, .v. This represented the present value of the $5 million sales price less the expected insurance and taxes. Jt. Stip. 4 ¶ 11.u.

Moore questioned whether one of the criteria under SAB 104—persuasive evidence of an arrangement—was met (Tr. 90, 135-137; Ex. J-1 at 6), but, as discussed below, devoted little evident attention to the two criteria at issue here or to FIN 46(R).

a. Moore Relied on Management Representations To Conclude That Collectibility of the Sales Price to VLC Was Reasonably Assured Under SAB 104.

According to management's accounting memorandum, management concluded that collectibility of the sales price was reasonably assured because VLC was "formed by CCH Netherlands, a European bank," and "[a]s such, management believes that VLC has the resources to ensure collectibility of the purchase price. In addition, VLC has already placed the $500,000 in escrow as of June 29, 2007." Ex. J-1 at 4.

Moore testified that when she reviewed Basin Water's accounting for the VLC I transaction, the involvement of CCH Netherlands was a material factor in her analysis and conclusion that VLC had the resources to ensure that Basin Water would be able to collect the purchase price in the first SPE transaction. Tr. 94-96. Moore's review included reading the letter agreement between Basin Water and VLC and management's memorandum discussing the transaction. In addition, during the year-end 2007 audit, Moore relied on a third document, a 2008 confirmation from the managing member of VLC I.

Moore testified that she understood, based on management representations, that CCH Netherlands had "caused VLC to be formed" and had the wherewithal to support VLC. Tr. 96-97; Ex. J-1. Moore also testified that at the time she evaluated the VLC I transaction she had never heard of CCH Netherlands, did not know its size, total assets, capitalization, or credit rating. Tr. 100. Yet Moore testified that she did not contact CCH Netherlands to verify its obligations to VLC and was not aware of any procedures or steps taken by anyone else on the engagement team, either during the second quarter 2007 review or during the 2007 audit, to do so. Tr. 97-98. Moore satisfied herself only that CCH Netherlands existed, by doing research on the internet. Tr. 100-101. She testified that this basic internet research, and management's representations in its accounting memorandum for the VLC I transaction, were the only evidence she gathered regarding CCH Netherlands' relationship with VLC. Tr. 101; 138. Only when Moore led the restatement audit in 2008 did she receive a copy of the operating agreement for VLC, which revealed the SPE had been formed with a capital contribution by its sole member, the Texas-based attorney, of only $1,000, and CCH Netherlands had not contributed any equity but had instead agreed to loan VLC the money to make the down payments due to Basin Water. Ex. D-13 at 29; Tr. 378-80.

Moore also testified that, during the 2007 audit, she understood from management that CCH Netherlands had provided a $500,000 equity investment in VLC. Tr. 73, 96-97. Yet Moore stated that she did not contact VLC or the escrow agent to confirm that the $500,000 down payment had been made as of June 29, 2007, as represented by management's accounting memorandum, and she was unaware of any efforts by others on the engagement team to contact VLC or the escrow agent to confirm it. Tr. 103-104.

When Moore did see the VLC I escrow documents for the first time in 2008 in connection with the restatement audit, those documents demonstrated that the $500,000 down payment for the VLC I transaction had not been placed in escrow on June 30, 2007, as represented in the letter agreement. Instead, VLC and Basin Water had amended the escrow agreement on October 19, 2007 to provide that VLC would deposit only $311,000 into escrow, while Basin Water itself was to supply $189,000 to make up the aggregate $500,000 down payment. Ex. D-10 at 19. The escrow account had been fully funded on October 19, 2007, but Basin Water received no proceeds in 2007—that is, the down payment sat uncollected in the account through the end of 2007 and, as Moore learned from the restatement, for most of 2008. Ex. D-11 at 20; Tr. 201. The escrow documents show that Basin Water did finally receive some of the down payment in September 2008, but only $200,000—representing $50,000 for each of only four (out of ten) consents from end users to assign their leases to VLC that Basin Water needed to collect. Ex. D-11 at 20. Thus, even as late as the third quarter of 2008, Basin Water had done little more than recoup its initial $189,000 contribution to its own down payment.

During the 2007 audit Moore continued to rely on management's representation that placement of the down payment into escrow on June 29, 2007 supported collectibility even though she became aware of contrary evidence. Namely, management provided Moore with a purchase agreement executed by VLC and Basin Water on September 14, 2007 that called for placing the down payment into escrow on September 7, 2007, over six weeks after it had purportedly already been placed in escrow. Ex. D-9 at 3; Tr. 161-62. This contradicted Basin Water's Form 10-Q filing for the quarter ended June 30, 2007, in which management disclosed that the net proceeds of the transaction included $500,000 in cash paid by VLC. Jt. Stip. 4 ¶ 11.v; Tr. 218.[7/]

In a November 2, 2007 email, while engagement team members began to evaluate a later SPE transaction from the third quarter (WSS I, discussed below), Moore asked the team's senior manager, "[D]id they ever fund the VLC transaction?" Ex. D-27 at 1. Moore noted further that "there was some funding or something that was supposed to occur and hadn't even by the time the [Form 10-]Q had [been] filed [in August 2007]. I remember being irritated by that." Ex. D-27 at 1; *see* Jt. Stip. 4 ¶ 11.v. The senior manager replied, "[Y]ou're thinking of the 500K down payment that was not received—I'm calling [the CFO] and I'll find out because this one has a down payment as well. A much bigger one." Ex. D-27 at 1. Moore testified she did not recall the senior manager ever reporting back to her on this issue, did not recall doing anything with the knowledge that the funding had not occurred by the time the Form 10-Q had been filed on August 14, 2007, and did not recall asking management anything about it. Tr. 220-222.

During the 2007 audit, Moore was provided with additional information that contradicted management's representations that Basin Water had received the down payment for the VLC I transaction. Specifically, Moore knew that the year-end

[7/] Moore testified that she did not notice when she saw the purchase agreement at the time of the 2007 audit that the execution date of the agreement postdated the purported closing date. Tr. 161. The agreement referenced four exhibits: an asset list, a loan agreement, a security agreement, and an escrow agreement. Ex. D-9 at 1, 3. Moore claimed at the hearing that she saw those exhibits but conceded that she did not obtain copies for the files and that no copies of the exhibits exist in the 2007 audit work papers. Tr. 167-68. Later during the hearing, she testified that she did not recall reviewing the escrow agreement, which would have been attached to the September purchase agreement. Tr. 180. This escrow agreement appears in SingerLewak's work papers for the restatement audit, as discussed below.

receivables reconciliation schedule provided by management showed that the down payment was still due from VLC as of December 31, 2007. Jt. Stip. 5 ¶ 11.ee; Tr. 174-75; Ex. D-2 at 2. Yet Moore testified that she did not recall anyone on the engagement team contacting the escrow agent during the 2007 audit, did not recall instructing any other team member to do so, and did not recall anyone on the team receiving any escrow agreement. Tr. 178-180. She further testified that if someone had received the escrow agreement in the 2007 audit, she would expect that to be documented in the audit work papers and that she was not aware of any such documentation. Tr. 180. Moore testified that she had a "recollection of the team seeing an escrow statement during the audit of 2007" but didn't "really recall the details" and conceded she saw no evidence of such a document in the audit files. Tr. 138-39.

Also during the 2007 audit, Moore received a confirmation letter from VLC dated March 4, 2008 that purported to confirm the amount VLC owed to Basin Water for the VLC I transaction as of December 31, 2007. Ex. J-4; Tr. 201-202. On its face, the letter confirmed VLC owed Basin Water $3.85 million, but that figure reflected the internally discounted amount that Basin Water considered due to it, not the $4.5 million that VLC actually had to pay for the transaction (*i.e.*, $5 million purchase price minus the $500,000 down payment, to be paid in 72 monthly installments of $62,500 each). Ex. J-4; Tr. 201-202. At the hearing, Moore acknowledged that the letter was part of the 2007 audit work papers, that she had reviewed it during the audit, and that "[t]here is clearly a difference between the face value of the note that VL Capital signed and the discounted balance per the books of Basin." Tr. 209. She testified that, given that discrepancy, she "would have expected an explanation," but conceded that none was documented. Tr. 209-210.

b. Moore Relied on Management Representations To Conclude That Basin Water Delivered the Water Treatment Systems to the Buyer Under SAB 104.

With regard to the SAB 104 revenue recognition criterion that delivery has occurred or services have been rendered, Basin Water management commented in its accounting memorandum that the water treatment systems sold to VLC "have already been delivered to customers and placed into operation by [Basin Water]," and thus, Basin Water had "substantially accomplished what it must do pursuant to the terms of the arrangement to complete delivery of the systems." Ex. J-1 at 3. Moore testified that she agreed with this conclusion during the second quarter 2007 review and the 2007 audit. Tr. 90-91.

Moore understood at the time of the 2007 audit, however, that Basin Water had to take other steps to meet its performance obligations. She knew that Basin Water was required to obtain consent to assign the lease payments from each of its end-user customers. Jt. Stip. 5 ¶ 11.aa. She testified that, at the time of the VLC I transaction, she had a concern that, if management did not receive these consents, revenue recognition could be inappropriate because the transaction would be incomplete. Tr. 171; Ans. 17 ¶ 33; *see* Ex. D-151 at 34-35.

Moore tried to address this concern by orally requesting that engagement team members sample the end user contracts to see whether Basin Water had a contractual right to assign the leases. Tr. 172; Ans. 16-17 ¶ 32. The team members reported back that the sample they tested appeared to give Basin Water the right to assign the leases. Ans. 16-17, ¶ 32. Moore did not recall reviewing any documentation of the team's sampling of leases subject to the VLC I transaction (Tr. 172), but she understood that nothing prohibited consents from being obtained, "so it was perfunctory" (Ans. 17 ¶ 33).

Moore testified that Basin Water management told her they had received the required consents. Tr. 171; *see* Jt. Stip. 5 ¶ 11.bb; Ans. 17 ¶ 33. Moore obtained no evidence to corroborate this assertion. She testified that she never saw copies of written consents and she did not recall anyone else on the engagement team doing so. Tr. 171. Moore's understanding that the consents had actually been obtained was based entirely on conversations with Basin Water management. Tr. 171-72.

In fact, by the end of 2007, Basin Water had obtained no consents. As noted above, the company showed the $500,000 down payment on its books as an unbilled receivable as of December 31, 2007. Jt. Stip. 5 ¶ 11.ee; Ex. D-2 at 2. Under the terms of the escrow agreement for the $500,000 down payment, which Moore did not obtain until the restatement audit, Basin Water would receive a $50,000 disbursement for each end user consent it provided. Ex. D-10 at 3, 19-20; Tr. 178-181; *see* note 5 above. Thus, Basin Water would receive all of the $500,000 due to it only after collecting and providing the consents relating to all ten equipment leases.

c. Moore Relied on Management Representations To Conclude That VLC Was Not Thinly Capitalized, and Therefore Not a VIE Possibly Requiring Consolidation of Basin Water's Financial Statements With VLC's, Under FIN 46(R).

Moore understood that an entity is a VIE if it is "thinly capitalized." Ex. D-36 at 4. An entity is thinly capitalized where the "total equity investment is not sufficient to finance its activities without additional subordinated financial support" such as loans and lease guarantees. Once an entity is identified as a VIE, then the "risks and rewards model should be applied," and "the party who participates in the majority of the entity's economics" by virtue of "contractual arrangements" should consolidate its financial statements with those of the VIE. Ex. D-36 at 4.

Moore was also aware that American Institute of Certified Public Accountants (AICPA) Practice Alert 2005-1, entitled *Auditing Procedures with Respect to Variable Interest Entities* (Practice Alert 2005-1), "provides guidance to auditors in planning and performing auditing procedures with respect to VIEs." Ex. D-36 at 9. This Practice Alert, included in Moore's own training materials as a handout, states that an auditor should, among other things, review any operating agreements or other contracts to determine whether the nature and extent of such transactions may necessitate consolidation of the entity's financial statements. Ex. D-36 at 13-20; Tr. 324-26. It also specifies various procedures that should be considered in investigating the capital structure of a potential VIE, including inspecting evidence in the possession of the auditee's counterparties, confirmation of significant information with intermediaries, and performing tests to determine whether the auditee correctly applied FIN 46(R). Ex. D-36 at 15-16. Moore's training presentation concludes with a slide that states, "When in doubt? ***CONSOLIDATE***." Ex. D-36 at 9 (emphasis in original).

Moore understood when leading the second quarter 2007 review of the VLC I transaction that VLC was a special purpose entity and that VLC had been newly created for the transaction. Tr. 77-78. Moore knew that it was necessary to evaluate whether Basin Water had to consolidate its financial statements with VLC's because, if consolidation were required, then any revenue Basin Water recognized on the SPE transaction would be eliminated. Tr. 120-21; Ans. 18-19 ¶ 36; Jt. Stip. 3, ¶ 11.o. She also understood, from discussions with management in May 2007, that management had been contemplating structuring the transaction such that rules requiring consolidation would not apply. Tr. 120.

Basin Water management's memorandum in support of revenue recognition for the VLC I transaction contained no discussion of FIN 46(R), and Moore does not recall receiving or seeing a documented analysis of FIN 46(R) from management. *See* Ex. J-1; Tr. 118. When the company restated its 2006 and 2007 financial statements in a Form 10-K/A filed February 10, 2009, Basin Water disclosed that it had "incorrectly recognized" $8.3 million of revenue in connection with the four SPE transactions "as a result of the failure to apply Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities—Deferral for Certain Interests, Revised December 2003* (FIN 46(R))." Ex. D-46 at 4; *see also* Ex. D-46 at 5, 103. According to the memorandum Basin Water management prepared during the restatement discussing the accounting for the SPE transactions, the company had determined that the SPEs were "thinly capitalized" and unable to absorb the losses if the end users of the water treatment systems did not make their lease payments. Ex. D-17 at 3. The memorandum that SingerLewak prepared, and Moore reviewed, assessing whether fraud was involved in the original Basin Water financial statements for 2006 and 2007 concluded with regard to the VLC transactions that "the restatement was caused by Management's negligence to assess the FIN 46(R)." Ex. D-39 at 4; Tr. 386. Moore testified that she never requested that the company prepare a documented analysis of FIN 46(R) (Tr. 118), and there is no documentary evidence in the record that SingerLewak performed a FIN 46(R) analysis for the SPE transactions, though it had performed and documented one for a different 2007 transaction.[8/]

Despite the lack of a documented FIN 46(R) analysis by management, Moore testified that she concluded that VLC "did not need to be consolidated with Basin [Water]" as a result of the application of FIN 46(R). Tr. 121-22. In support of her conclusion, Moore testified it was her understanding that VLC was not thinly capitalized. Tr. 122-23. She testified this understanding was based on the receipt by Basin Water of a $500,000 down payment, whose source management characterized as an "equity" contribution by CCH Netherlands. Tr. 122-23. But Moore admitted she never requested or saw any documents showing that the $500,000 down payment was to be contributed to VLC as an equity investment, as compared to a loan. Tr. 123-24. Moore conceded that she depended entirely on Basin Water management's representation that the money would be contributed to VLC as equity. Tr. 120-24.[9/]

Moore testified that, in connection with the 2007 audit, she requested the operating agreement for VLC or some other documentation such as VLC financial statements that would show the equity structure of the SPE, but Basin Water management said that it did not have the information. Tr. 141-45. She testified that she had a "conversation" with the SingerLewak concurring partner for the audit about management's lack of information about VLC, but conceded that when management informed her that it felt it had no right to request such information from VLC, she ended her inquiry into the capitalization of VLC at that point. Tr. 141-45.

Furthermore, Moore did little to inquire into whether, besides the sufficiency of its capitalization, VLC had other characteristics enumerated in FIN 46(R) that might render it a VIE and, in turn, require further analysis as to whether Basin Water was the primary beneficiary and thus had to consolidate VLC's financial statements with its own. Moore testified that she recalled asking management "a couple questions regarding VLC's rights on the [water treatment] units, whether they could sell the units or not," but did not confirm that VLC's rights were necessarily representative of its equity investors' rights.

[8/] As noted *supra* in Section III.A and *infra* in Section VI.A, on March 13, 2008, management had prepared, and Moore approved, an accounting memorandum discussing a different 2007 transaction that included a FIN 46(R) analysis. Ex. GM-1.

[9/] In fact, as discussed below, Moore learned during the restatement audit that CCH Netherlands committed only to a loan, not an equity investment, in backing the VLC I transaction, and that VLC's only capital was a $1,000 contribution by the Texas attorney who was the sole member of VLC.

Tr. 149-50. She did not obtain any evidence establishing the equity investors' obligation to absorb expected losses of VLC and did not recall instructing anyone else on the engagement team to do so. Tr. 150-51. Nor did she or any other team member obtain evidence regarding the proportionality of equity investors' voting rights. Tr. 152-54.

When asked if she instructed anyone else on the engagement team to obtain evidence to establish the primary beneficiary of VLC, the required next step in a FIN 46(R) analysis when deciding whether to consolidate financial statements, Moore did not directly answer the question, but rather testified generally that "I believe I discussed making sure that we had FIN 46 documented correctly in our files. I had that discussion with [the engagement team's senior manager]." Tr. 154. But she conceded that no such documentation appears in the record. Tr. 154-55. For his part, the senior manager testified that the engagement team "requested management to put forth in a memo their—their analysis of FIN 46," but he could not recall whether it appeared in the work paper files. Nor did he recall, in response to Moore's question, an incident in which Moore became "very concerned" when she could not locate any FIN 46(R) documentation during the restatement audit. R.D. 47b at 478-79. The senior manager recalled that there were "many instances" in which the audit software SingerLewak used "crashed, and we had to redo work that was already performed," including during the audit of Basin Water. R.D. 47b at 481-82. He also testified, however, that, as far as he was aware, any work that needed to be redone was, in fact, redone. R.D. 47b at 500-01. As noted above, Basin Water, during the restatement that followed the 2007 audit, disclosed that it had incorrectly recognized revenue from the SPE transactions "as a result of the failure to apply Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities—Deferral for Certain Interests, Revised December 2003* (FIN 46(R))." Ex. D-46 at 4; *see also* Ex. D-46 at 5, 103.

3. Moore Accepted Management's Conclusion That Recognition of Revenue for the WSS I Transaction Was Appropriate.

Moore reviewed the second SPE transaction (WSS I), entered into by Basin Water and WSS at the end of the third quarter of 2007, as part of the procedures performed for that quarter's review, and relied upon those procedures during the annual audit. Jt. Stip. 5 ¶ 11.jj. As noted, Moore understood that the WSS transaction required greater attention and presented a risk that revenue might be improperly recognized during 2007. *See* Ex. J-7 at 3; Jt. Stip. 3 ¶ 11.n; Tr. 43-47.

During Moore's review, management provided her with a letter agreement dated September 14, 2007, that described the terms of the transaction. Jt. Stip. 5 ¶ 11.ff. As Moore knew at the time of the 2007 audit, under the terms of that agreement, Basin Water agreed to sell to WSS water treatment systems being constructed for lease to a city. The sales price was $4,400,000 (less the estimated present value of expected costs of insurance and property taxes). WSS agreed to make an initial deposit of $25,000 to be held in escrow pending the execution of definitive documentation. Once the city accepted the treatment systems, WSS would make a $2 million down payment (minus approximately $500,000 for insurance and property taxes). The balance of the purchase price would be financed by Basin Water; that is, Basin Water would receive an interest-bearing note with monthly payments to begin the 61st month of the underlying lease term. In return, Basin Water agreed to assign to WSS the lease payments to be paid by the city to Basin Water. Tr. 210-12; Jt. Stip. 5 ¶¶ 11.ff, .gg.

a. Moore Relied on Management Representations To Conclude That Collectibility of the Sales Price to WSS Was Reasonably Assured Under SAB 104.

Management provided Moore with a memorandum, dated October 31, 2007, that explained the basis for its accounting for the WSS I transaction. Jt. Stip. 5 ¶ 11.hh; Ex. D-15. This memorandum was similar to the VLC I memorandum and addressed three issues, of which the relevant one here is revenue recognition under SAB 104, and more specifically the collectibility of the sales price from WSS.

In the WSS I memorandum, management concluded that all four SAB 104 criteria were satisfied, just as it had in connection with VLC I, and that revenue for the WSS I transaction could be recognized in the third quarter of 2007. Ex. D-15 at 7. The WSS I memorandum stated that the letter agreement constituted persuasive evidence of an arrangement, that the agreement set a fixed price, and that Basin Water's commitment to the particular city involved to place the equipment with it and the fact that Basin Water had substantially completed manufacturing the equipment satisfied that delivery requirement. Ex. D-15 at 3-7. At issue is Moore's assessment of management's conclusion that the sales price to WSS was collectible, for which the WSS I memorandum relied on two facts: (1) that WSS was "backed" by National City (described as a large Chicago bank), which Basin Water management concluded had "the resources to ensure collect[i]bility," and (2) that $25,000 had "been placed in an escrow account." Ex. D-15 at 4.

The engagement team's notes show that the team agreed with management that revenue recognition was appropriate but noted that revenue should be calculated on the percentage-of-completion basis, because Basin Water was still in the process of manufacturing the equipment for the system. Ex. D-15 at 7. These notes further indicate that the team relied on the letter agreement between Basin Water and WSS for its conclusions regarding the four SAB 104 criteria. Ex. D-15 at 7. Moore testified that she reviewed the memorandum and the notations made by the other team members and concluded at the time of the 2007 audit that the procedures performed were sufficient and properly documented. Tr. 227-28.

As noted, two facts were critical to Basin Water's conclusion in the memorandum that revenue for the WSS I transaction could be recognized. First was National City's "backing" of WSS. Moore testified that she understood that "[i]f National City was not able to support WSS, WSS would not be able to perform its obligations under this contract." Tr. 243-44. She stated that National City was a member and equity contributor to WSS, but she acknowledged that the only basis for this belief was Basin Water management's representation. Tr. 242-45. She did not herself contact National City, nor did she instruct anyone else to do so. Tr. 237-38. Moore testified that she had a "vague recollection of seeing some communication or something" from National City but could not recall specifics. Tr. 239-240. The 2007 audit work papers contain no support for the relationship between National City and WSS. Tr. 240-41.

The second fact critical to Basin Water's conclusion on collectibility was that a $25,000 deposit had purportedly been placed in escrow. Yet Moore testified she did not believe she or anyone else on the engagement team performed any procedures to determine whether that in fact had occurred. Tr. 245. At any rate, she conceded at the hearing that a $25,000 deposit on a $4.4 million transaction was not a sufficient basis for determining that collectibility was reasonably ensured. Tr. 245-46. Moore learned during the restatement audit that National City had never actually provided the $25,000 and concluded that "the sale [h]as not met criteria to recognize revenue when contract was signed." Ex. D-13 at 29; Ex. D-16 at 3; Ex. D-39 at 3-6; Tr. 378-80.

b. Moore Relied on Management Representations To Conclude That WSS Was Not Thinly Capitalized, and Therefore Not a VIE Possibly Requiring Consolidation of Basin Water's Financial Statements With WSS's, Under FIN 46(R).

Moore was aware at the time of the 2007 audit that WSS was an SPE formed for the specific purpose of entering into sales transactions with Basin Water. Jt. Stip. 3 ¶ 11.j. The WSS I memorandum prepared by management, like the VLC I memorandum before it, did not address consolidation or FIN 46(R). Ex. D-15; Tr. 247. Moore testified that she did not have a specific conversation with management related to FIN 46(R), and did not recall seeing any FIN 46(R) analysis prepared by management in connection with this transaction. Tr. 247-48.

Moore testified that she concluded that WSS did not need to be consolidated because it was sufficiently capitalized, and that she based her conclusion on management's assertions. Tr. 250-51. Moore stated that she did not obtain the operating agreement for WSS or any evidence about the equity holders of WSS or their rights and obligations. Tr. 283. During the restatement audit, Moore learned that National City had not promised to furnish equity funding to WSS but only to provide a loan, and, as noted above, that National City had not actually provided even that. Ex.

D-13 at 29; Tr. 378-80. Moore testified that this information caused her to conclude during the restatement that WSS was thinly capitalized and that, had the transactions been completed, the financial statements of WSS should have been consolidated with Basin Water's. Tr. 378-79, 384.

When the hearing officer asked Moore whether she believed that "FIN 46 is a fairly important analysis in this kind of context," Moore replied, "That is correct." Tr. 249-50. Moore testified she "would recall" seeing a FIN 46(R) analysis if the engagement team had prepared one, and conceded she could not recall seeing one. Tr. 250.

4. Moore Relied on Management Representations To Conclude That Recognition of Revenue for the WSS II Transaction Was Appropriate Under SAB 104 and Did Not Consider Whether Consolidation of the Financial Statements of Basin Water and WSS Was Necessary Under FIN 46(R).

The engagement team evaluated the third SPE transaction (WSS II), entered into by Basin Water and WSS at the end of the fourth quarter of 2007. As part of that process, Basin Water management provided to the team a purchase agreement dated December 26, 2007, which described the terms of the transaction. Ex. D-33; Tr. 287-88. Moore testified that she didn't "recall right now at this point" whether she actually saw the WSS II purchase agreement during the 2007 audit. Tr. 288.

As Moore understood, the purchase agreement provided that Basin Water would sell to WSS for $1,353,079 certain water treatment systems being constructed for lease to a municipality. Jt. Stip. 6 ¶ 13.a; Ex. D-33. WSS was to deposit $5,000 into an escrow account, which would be payable to Basin Water 30 days after the municipality accepted the treatment systems. Jt. Stip. 6 ¶ 15; Ex. D-33. WSS was to pay another $561,606 directly to Basin Water 30 days after delivery, and the balance of the sales price ($786,473) plus 5% interest was to be paid beginning five years later. Jt. Stip. 6 ¶¶ 13, 15; Ex. D-33. In return, Basin Water agreed to assign all lease payments due to it from the end user. Jt. Stip. 6 ¶ 15. Basin Water recognized approximately $1.3 million in revenue in 2007 in connection with the WSS II transaction, using the percentage-of-completion method of accounting. Jt. Stip. 6 ¶ 13.b.

The audit file contains no memorandum by Basin Water management to support its accounting for WSS II. Tr. 301. Moore testified that she did not ask Basin Water management to prepare any such memorandum, and to her knowledge, no one else on the engagement team asked management to prepare one. Tr. 301-02. Nonetheless, Moore testified that she understood that management concluded that the criteria in SAB 104 for revenue recognition in the WSS II transaction were satisfied and that the company's rationale for that conclusion was the same as for the WSS I transaction.

Tr. 303. As with the WSS I transaction, neither Moore nor anyone else on the engagement team performed any procedures to assess whether collectibility under SAB 104 was supported by National City's "backing" of the WSS II transaction. Tr. 304. As with the WSS I transaction, Moore learned during the restatement process that National City never provided the $5,000, and thus the transaction was reversed, eliminating the revenue based on it.[10/]

Moore testified that, at the time of the 2007 audit, she understood that a FIN 46(R) analysis of the WSS II transaction was required. Tr. 304-05. She also testified that even if a conclusion had been reached that the WSS I transaction did not require consolidation of WSS's financial statements with Basin Water's, that conclusion needed to be reassessed after the WSS II transaction, including an examination of whether WSS's capital structure had changed. Tr. 305; *see* Ex. D-36 at 14-15. Yet Moore testified that during the 2007 audit she was never aware of management performing a FIN 46(R) analysis in connection with the WSS II transaction and that she did not perform one. Tr. 304. At no time after the WSS II transaction and before the issuance of the 2007 audit report did Moore obtain any evidence about WSS's capital structure, nor, to her knowledge, did anyone else on the engagement team. Tr. 305-06. As noted above, Moore learned during the restatement audit that National City had not promised to furnish equity funding to WSS but only to provide a loan, which led her to conclude that, had the transactions been completed, the financial statements of WSS should have been consolidated with Basin Water's. Ex. D-13 at 29; Tr. 378-80.

5. Moore Relied on Management Representations To Conclude That Recognition of Revenue for the VLC II Transaction Was Appropriate Under SAB 104 and Did Not Consider Whether Consolidation of the Financial Statements of Basin Water and VLC Was Necessary Under FIN 46(R).

The engagement team was provided with a copy of a letter agreement describing the fourth and final SPE transaction (VLC II), entered into by Basin Water and VLC on

[10/] The $1.332 million in revenue Basin Water recognized for this transaction was based on the WSS II contract price ($1.353 million) plus an additional $285,000 in fees due from the end user. Ex. D-33 at 1; Jt. Stip. 6, ¶ 14. A confirmation the engagement team received showed that WSS agreed to the sales price of $1.353 million but did not mention the $285,000 fee. Ex. D-34. The team noticed the difference but did not explain in the related audit documentation or elsewhere in the work papers why the $285,000 was an appropriate addition to revenue. *See* Tr. 291. This was the subject of a charge against Moore in the OIP, but it was not specifically addressed in the initial decision's findings of violations or by the parties on appeal, so we do not consider it.

the last day of the year, December 31, 2007, five days after the WSS II transaction. Jt. Stip. 6 ¶¶ 16, 17; Ex. D-14. As Moore was aware during the 2007 audit, under that agreement, Basin Water was to sell for $763,330 certain water treatment systems to VLC that were still being constructed for lease to an end user. Jt. Stip. 6 ¶ 16.a. In the agreement, the end user was identified in the purchase agreement only as "client," and the description of the property covered by the agreement was left blank. Ex. D-14; Tr. 312-13. VLC was to pay a down payment of $10,000 immediately into a trust account. Upon acceptance of the system by the end user, the down payment would be released, and VLC was to pay Basin Water directly an additional $30,568 and give Basin Water a note payable for $722,761, which was the balance of the purchase price to be repaid in monthly installments. The monthly installments would begin 255 days after acceptance of the system by the end user. Jt. Stip. 6 ¶ 17. In return, Basin Water agreed to assign to VLC all lease payments due to it. But the amortization schedule attached to the agreement showed that, even after all monthly installments were paid, a balance due to Basin Water of $321,000 would remain. Ex. D-14. During the fourth quarter of 2007, the company started recognizing revenue in connection with VLC II on a percentage-of-completion basis. Jt. Stip. 6 ¶ 16; Ex. D-39 at 4; Tr. 307.

Moore understood at the time of the 2007 audit that period-end transactions, such as the WSS II and VLC II transactions, which occurred within five days of year end, generally require additional scrutiny. Tr. 309-10. She knew that there is a risk with such transactions that management might be trying to recognize revenue earlier than is appropriate. Tr. 310. She conceded that recording a transaction at the very end of a period could suggest that management is trying to reach some kind of revenue or income goal for the period. Tr. 310-11. Nevertheless, Moore did not recall performing or reviewing any specific procedures related to the VLC II transaction. Tr. 311-12. Moore testified that some red underlining that appears on the letter agreement was "not inconsistent with" marks that the engagement team would make during its testing (Tr. 309), but there is otherwise no evidence of any work the team did to support its conclusion that management's decision to recognize revenue for the VLC II transaction was appropriate. Moore acknowledged that there is no documentation in the audit work papers of any discussions between her and Basin Water management relating to the transaction. Tr. 312. Basin Water did not prepare a memorandum in support of its accounting for the VLC II transaction, as it had done with the VLC I transaction. Tr. 314.

Moore testified that she understood at the time of the 2007 audit, based on management representations, that CCH Netherlands was involved with the VLC II transaction. Tr. 314. Moore was unaware of any procedures undertaken to assess whether CCH Netherlands was, in fact, involved in any capacity. Tr. 314. Moore did not know if the engagement team performed any procedures to determine how the $321,000 outstanding balance on the amortization schedule was to be paid, and she was unaware of any documentation in the work papers explaining how it would be paid.

Tr. 315-18; Ex. D-14. Moore also was unaware if any procedures were performed by anyone else on the engagement team to determine if the $10,000 down payment had been made into the trust account, as provided in the purchase agreement. Tr. 315.

Although Moore testified that she had concluded in connection with VLC I that the financial statements of VLC did not need to be consolidated with Basin Water's under FIN 46(R), she also testified that she knew that the new transaction, VLC II, required that she reexamine her earlier conclusion. Tr. 319. She understood that the new transaction represented a change in circumstances, which might affect the capitalization of the SPE and therefore her conclusion as to whether VLC had to be consolidated. Tr. 319-20. But Moore testified that she did not recall performing a FIN 46(R) analysis in connection with VLC II and that she was unaware of anyone else on the engagement team doing so. Tr. 319. As noted above, when Moore received the operating agreement for VLC during the restatement audit in 2008, she learned that the SPE was capitalized with only $1,000 and that CCH Netherlands had not contributed any equity to the transaction, leading her to conclude during the restatement that the financial statements of VLC should have been consolidated with Basin Water's. Ex. D-13 at 29; Tr. 378-80.

D. Moore Failed to Question Management's Basis for Reducing Its Contract Loss Reserve Despite Knowing the Company Previously Revised Its Estimate to Avoid Reliance on Certain Assumptions.

As Moore knew at the time of the 2007 audit, Basin Water management recorded a reserve for all probable and reasonably estimable contract losses generated by service contracts under which the company maintained the water treatment systems it sold and leased. Ans. 31 ¶ 67. In its 2007 financial statements, Basin Water determined to eliminate the reserve for the final seven years of a particular ten-year water district contract entered into in January 2006 that had lost $179,052 in 2007 and was projected to lose $195,433 in 2008. Jt. Stip. 7 ¶¶ 18.f, 19. As Moore knew, management had identified this contract during the third quarter as among "the top 5 problem wells for 2007." Jt. Stip. 7 ¶ 21. Even so, management reduced the reserve for that contract by approximately $1.8 million in the 2007 financial statements, a reduction of almost 20% of the total loss reserve. Jt. Stip. 7 ¶ 20; Ex. D-46 at 6, 130.

Management's stated reason for that decision is documented in a SingerLewak work paper reviewed by Moore. Ex. D-68; Tr. 333-49. According to that document, management noted that "[t]his client is requesting" to expand its water treatment facility and that, with the "ability to increase pricing, it is expected that this will be a profitable plant." Tr. 340 (quoting full electronic version of Ex. D-68 at 157); Jt. Stip. 7 ¶ 23. Management decided that it would "assume breakeven (after noncontrollable expenses, including capital) from 2008 on." Ex. D-68.

Moore testified that this was the second year in which the client had prepared this contract loss reserve estimate, and there "had been an issue in the first year that they had built a lot of unenforceable assumptions into their reserve, and they had to go back and revisit it once we had discussions with them." Tr. 343. Aware of management's decision to revise its estimate in 2006, Moore testified that she discussed the estimate with the engagement team's senior manager during the third quarter review and specifically instructed him that the team "can't rely on assumptions that aren't legally enforceable" and it "couldn't rely on the note that management had put in that—that spreadsheet." Tr. 342-44. Moore concedes that she did not document these instructions. Tr. 352-53. Nonetheless, Moore believed that her instructions had been followed because "we did audit testing during the audit to test through the assumptions that are used to build up the reserve," but she conceded that this particular contract was not selected for the 2007 audit test work and had been reviewed only in connection with work done during the third quarter review. Tr. 341-55, 394-95.

There is no evidence in the work papers that Moore or any other member of the team questioned the basis for management's determination to reduce the reserve or that they gathered any evidence to support management's conclusion that the reduction was appropriate. Nevertheless, Moore testified at the hearing that when she "looked at the assumptions" management made about the well's increased capacity during the 2007 audit, she learned that "the well had become profitable" in the fourth quarter of 2007. Tr. 345-46; Ex. D-147 at 60. She testified that this uptick in profitability at the end of the year (though for 2007 as a whole it had still generated a loss and was projected to generate a loss in 2008) is what caused her to conclude that management's estimate was still appropriate, but she admitted there was no evidence that management itself considered this uptick in its own calculations. Tr. 344-48, 367-68. Moore also conceded that the work papers contain no indication that this late-2007 profitability, and not the ill-supported assumption of increased capacity, was the basis for her conclusion that management's estimate was reasonable. Tr. 347-48, 367-68. The only documentation in the work papers for the water district contract loss estimate stated that management did not estimate losses beyond 2008 because it assumed future increased capacity and that the auditors accepted this as reasonable. Tr. 340 (specifically discussing district contract loss estimate as referenced in full electronic version of Ex. D-68 at 157); *see* Ex. D-68 at 1, D-97 at 1 (generally referring to future contract losses and mentioning "some of the older contracts" but not discussing in particular the district contract, which was recent).

When Basin Water restated its 2006 and 2007 financial statements in 2009, it disclosed in its Form 10-K/A that the company had under-accrued its contract loss reserve by approximately $1.8 million. Jt. Stip. 8 ¶ 27; Ex. D-46 at 5-6. The filing explained that Basin Water had "assumed that a possible facility expansion would result in higher service fees to the customer, thus eliminating estimated operating losses on this contract beyond 2008." Ex. D-46 at 6, 105. According to the Form 10-K/A, the possible expansion, which was not "contractually committed," should not have been considered in estimating the contract loss reserve. Ex. D-46 at 6, 105.

IV.

As summarized in the OIP, Moore is alleged to have "failed to exercise due professional care and professional skepticism in performing her work on the audit and failed to obtain sufficient competent evidential matter to afford a reasonable basis for the Firm's unqualified opinion expressed regarding Basin Water's 2007 financial statements. Among other things, she failed to obtain and evaluate sufficient audit evidence to form conclusions concerning the validity of Basin Water's financial statement assertions in (a) recognizing revenue for four transactions with special purpose entities and (b) valuing Basin Water's contract loss reserve." R.D. 1, OIP 1 ¶ 2.

Specifically, with regard to Moore's evaluation of Basin Water's accounting for the four SPE transactions, the OIP charged, as relevant here, that Moore violated PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, and Rule 3200T, *Interim Auditing Standards*, by:

- failing to exercise due professional care and skepticism, in violation of AU § 150, *Generally Accepted Auditing Standards*, and AU § 230, *Due Professional Care in the Performance of Work*;

- failing to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion, in violation of AU § 150 and AU § 326, *Evidential Matter*;

- failing to obtain sufficient competent evidential matter to form conclusions concerning the validity of assertions in Basin Water's financial statements as to the revenue recorded for the SPE transactions, in violation of AU § 326.13;

- failing to evaluate the business rationale for the SPE transactions and whether that rationale (or lack thereof) suggested the transactions might have been entered into to engage in fraudulent financial reporting, as required by AU § 110.02, *Responsibilities and Functions of the Independent Auditor*, and AU §§ 316.66, .67, *Consideration of Fraud in a Financial Statement Audit*;

- failing to adequately evaluate the audit evidence obtained concerning Basin Water's transactions with VLC and WSS, as required by AU § 326.25, including relevant audit evidence contradicting Basin Water's financial statement assertions as to the revenue recorded for the SPE transactions;

- failing to evaluate the results of confirmation procedures used concerning the VLC I transaction, in accordance with AU §§ 330.15, .33, *The Confirmation Process*; and

- failing to prepare or to ensure the preparation of appropriate audit documentation demonstrating the procedures performed, the evidence obtained or considered, or the conclusions reached concerning SingerLewak's consideration of the application of FIN 46(R) to the SPE transactions, as required by Auditing Standard (AS) No.3, *Audit Documentation*, ¶ 6.a.

With regard to Moore's assessment of Basin Water's contract loss reserve, the OIP charged, as relevant here, that Moore violated PCAOB Rules 3100 and 3200T by:

- failing to exercise due professional care and skepticism, in violation of AU §§ 150 and 230;

- failing to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion, in violation of AU §§ 150 and 326;

- failing to obtain sufficient competent evidential matter to provide reasonable assurance that Basin Water's contract loss reserve estimates were reasonable under the circumstances and presented in accordance with applicable accounting principles, as required by AU § 342.07.b, .07.c, *Auditing Accounting Estimates*;

- failing to obtain sufficient competent evidential matter to form conclusions concerning the corresponding assertions in Basin Water's financial statements, as required by AU § 326.13;

- failing to adequately evaluate the audit evidence obtained concerning Basin Water's contract loss reserve, as required by AU § 326.25;

- failing to adequately direct the efforts of assistants who were involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished and failing to adequately review the work of assistants to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report, in violation of AU § 150 and AU §§ 311.11, .13, *Planning and Supervision*.

V.

The charges against Moore all concern audit work she has acknowledged performing or reviewing, as the auditor with final responsibility for the audit of Basin Water's financial statements for the year ending December 31, 2007, relating to the four SPE transactions and the year-end 2007 contract loss reserve. The Division bears the burden of proving by a preponderance of the evidence that Moore engaged in an act or practice, or omitted to act, in violation of PCAOB rules and auditing standards, as charged in this case. PCAOB Rule 5204; *see* Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. § 7215(c)(4); PCAOB Rules 5202(a)(1) and 5300(a). Our findings are based on a *de novo* review of the record. PCAOB Rules 5460(c) and 5465. We apply the auditing standards as they existed at the time of the alleged violations.

PCAOB standards require an auditor to exercise due professional care and maintain an "independence in mental attitude," including a "questioning mind and a critical assessment of [the] audit evidence" throughout the audit. AU §§ 150.02, 230.07. They require an auditor, who has a "responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error," to "gain an understanding of the business rationale" for "significant transactions that are outside the normal course of business for the entity," such as the SPE transactions, and, in understanding that rationale, to consider "whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economic substance of the transaction" and whether the transactions involve "parties that do not have the substance or the financial strength to support the transactions without assistance from the entity under audit." AU §§ 110.02; 316.66, .67.

The standards also require the auditor to perform procedures to obtain and evaluate sufficient competent evidential matter to afford a reasonable basis for the opinion expressed regarding the financial statements under audit and to form conclusions concerning the validity of assertions embodied in the financial statements, here involving the revenue recognized by Basin Water for the four SPE transactions and the amount of Basin Water's contract loss reserve, as well as to provide the necessary support that significant accounting estimates, such as the reserve, are "reasonable in the circumstances" and "presented in conformity with applicable accounting principles." AU §§ 150; 326, 326.13, .25; 330.15, .33; 342.07.b, .c. And the standards require that, when supervising the work of audit assistants, such as those assisting Moore in evaluating Basin Water's contract loss reserve, the auditor with final responsibility for the audit direct the assistants' efforts, which includes, among other things, "instructing assistants, keeping informed of significant problems encountered, [and] reviewing the work performed," and review their work to "determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report." AU § 311.11, .13.

The application of these fundamental auditing standards is often informed by other standards that apply in certain contexts. Of particular importance here is the principle in AU § 333, *Management Representations,* that when management makes representations to the auditor, they "are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU § 333.02. Rather, management representations are "a complement to other auditing procedures." *S.W. Hatfield, C.P.A.*, SEC Rel. No. 34-69930, 2013 SEC LEXIS 1954, *6 (July 3, 2013).

It is undisputed that Moore was aware that "significant audit risks" were associated with revenue-related accounts and the contract loss reserve "due to management aggres[s]ive revenue recognition approach and subjective estimates on reserve." Ex. J-7 at 3. The skepticism and audit procedures an auditor must incorporate into her work only increase when, as here, an audit presents high risk. *Gregory M. Dearlove*, SEC Rel. No. 34-57244, 2008 SEC LEXIS 223, *60-61 (Jan. 31, 2008) (the "unquestioning acceptance" of management's position was "a clear—and at least unreasonable—departure from the requirements of [applicable auditing standards] to apply greater than normal skepticism and additional audit procedures in order to corroborate management representations in a high-risk environment"), *aff'd*, 573 F.3d 801 (D.C. Cir. 2009).

Moore argues that she conducted the audit in a professional manner, that management may have intentionally withheld information from the auditors, and that documentation in the Basin Water audit file was lost due to computer malfunctions. MB 2, 3, 14. The Division urges us to "affirm the Hearing Officer's findings and sanctions" because, in the Division's view, nothing in Moore's submissions undermines the determinations in the initial decision or the "undisputed evidence in the hearing record" that demonstrates Moore's "pattern of simply relying on uncorroborated management representations for accounting conclusions in high risk areas." R.D. 62, Division of Enforcement and Investigations' Opposition Brief (DB) 2.

We find that the Division proved by a preponderance of the evidence that in the 2007 Basin Water audit Moore showed inattention to two high-risk audit areas and merely accepted management representations instead of performing audit procedures to obtain sufficient competent evidential matter. The Division also proved that Moore's evaluation of Basin Water's contract loss reserve estimate demonstrated a failure to gather evidence to support her audit conclusions and the need to follow up on the work of her audit assistants. As discussed in detail below, Moore violated multiple PCAOB auditing standards.

A. Moore's Evaluation of the Four SPE Transactions Violated PCAOB Auditing Standards.

1. Moore Failed To Appropriately Evaluate Management's Conclusion that Recognition of Revenue for the VLC Transactions Was Appropriate.

Basin Water management concluded that it could properly recognize revenue from the VLC I transaction because the criteria in SAB 104 were met. According to management, collectibility of the sales price was reasonably assured because VLC was "formed by CCH Netherlands, a European bank" and because VLC had placed a $500,000 down payment "in escrow as of June 29, 2007." Ex. J-1 at 4. Moore's acceptance of that reasoning and conclusion was based on nothing more than management's representation. Moore and the others on the engagement team performed no procedures and obtained no evidence to corroborate management's collectibility analysis. Moore did not contact CCH Netherlands to verify its obligations to VLC or instruct anyone else on the engagement team to do so, even though she had never heard of CCH Netherlands before the VLC I transaction and even though this transaction would account for 60% of Basin Water's revenue for the quarter and more than 20% of Basin Water's revenue for the year.

Moore also failed to perform procedures or obtain evidence to corroborate management's assertion that the $500,000 down payment had been paid into escrow on June 29, 2007. Neither she nor any other engagement team member contacted the escrow agent or VLC to confirm that, in fact, the payment had been made. Moore relied on management's representation that placement of the down payment into escrow on June 29, 2007 supported collectibility even though she was aware of contradictory evidence, including (1) a purchase agreement dated September 14, 2007 that still called for the payment of the down payment into escrow; (2) learning in the third quarter that the down payment had not been received by Basin Water prior to the second quarter 10-Q filing; and (3) a year-end receivables reconciliation schedule showing that the down payment was still due from VLC as of December 31, 2007.

Moore did not address clear discrepancies in the document the auditors obtained to verify the valuation of the VLC I note receivable. The March 4, 2008 confirmation letter, which she reviewed and accepted in the 2007 audit, confirmed a balance that was not consistent with the amount recorded on the books of Basin Water by more than $500,000. Yet the audit documentation stated that there were no discrepancies, and the confirmation was accepted as valid evidence of collectibility.

Moreover, Moore's acceptance of management's representations that consents had been obtained from end users—and that therefore deliverability of the promised asset was reasonably assured—also failed to meet basic auditing standards. Moore knew that Basin Water was required to obtain consent to assign the lease payments from each of its end-user customers, and she knew that without consents, revenue recognition could be inappropriate because the transaction would be incomplete. Moore testified that management told her the consents had all been obtained, but she admittedly gathered no evidence to corroborate this. All the engagement team did to address this contingency—which was critical to Basin Water's ability to collect the down payment and to completion of the contract—was to test a sample of leases to determine if the end users could legally provide the consents, thus failing to engage the issue of whether the end users actually had provided them. If Moore had requested to see the escrow statements, she would have learned that, as of December 31, 2007, no portion of the $500,000 down payment had been disbursed to Basin Water.

Moore's assessment of the VLC II transaction was even less rigorous, and so deviated even further from PCAOB standards. This transaction occurred on the last day of 2007, and Moore conceded that the timing of the transaction at the end of a reporting period could suggest that management was trying to reach some kind of revenue or income goal for the period. Tr. 310-11. Management did not prepare a memorandum to support its accounting for this transaction, and the letter agreement evidencing the transaction that is included in the work papers is incomplete and reflects that the monthly installments would result in a shortfall to Basin Water of $321,000. Despite these circumstances, Moore was aware of no procedures performed to address the clear discrepancy in the letter agreement, none to confirm that CCH Netherlands was involved in any capacity, and none to confirm that the $10,000 down payment required by the agreement was made. Moore's evaluation of management's conclusions as to revenue recognition for the VLC II transaction was essentially non-existent.

2. Moore Failed To Appropriately Consider Whether the VLC Transactions Required VLC To Be Consolidated into Basin Water's Financial Statements Under FIN 46(R).

Moore, an avowed specialist in the application of FIN 46(R), admitted that she knew it was necessary to consider whether, as a result of the VLC I transaction, VLC was required to be consolidated into Basin Water's 2007 financial statements under FIN 46(R). She also knew that if VLC were consolidated into Basin Water's financial statements, the revenue recorded in connection with the VLC I transaction would be eliminated as an intercompany transaction. Yet there is no evidence in the 2007 work papers of any consideration of FIN 46(R) by management, and there is no evidence in the work papers that Moore or anyone else on the engagement team considered FIN 46(R) with respect to the VLC I transaction or indeed any of the SPE transactions.

Moore claims she discussed consolidation under FIN 46(R) with management in May 2007. This discussion is undocumented, but in any event, two pieces of information she supposedly gained from it should have driven her to apply heightened scrutiny to the SPE transactions generally and to the VLC I transaction specifically. First, management told her the company was structuring the transactions to achieve revenue recognition and to avoid consolidation, which was consistent with the "aggressive" accounting approach that caused Moore to assess the audit as presenting an overall high risk of material misstatement. Second, management told Moore that the SPE transactions would feature substantial down payments in the range of 50%-70% of the sales price. Yet after she assessed the VLC I transaction as part of the second-quarter 2007 review, Moore did not question that the down payment was only 10%. (Nor did she question the size of down payments made in subsequent transactions, which were even smaller.)

Moore testified that she thought the information necessary to a FIN 46(R) analysis was contained in management's accounting memorandum for VLC I, although the memorandum did not expressly address FIN 46(R). Tr. 247-51. That memorandum, however, was concerned with the criteria in SAB 104 for determining whether revenue should be recognized, whether it was recognizable in the second quarter, and whether the transactions had to be treated as sale-leasebacks. The document does not even cursorily address issues critical to understanding the flow of economic risks and rewards that FIN 46(R) addresses, such as VLC's capital structure or VLC's equity investors' ability to control VLC's activities. As the Division's expert noted, it is a commonly held view in the accounting and auditing profession that "a FIN 46(R) analysis is a complex and detailed analysis" that cannot be done with a casual mental calculation. Ex. D-151 at 38. The information in management's memorandum does not contain the information necessary to support a competent FIN 46(R) analysis.

Although there is no supporting documentation in the record, Moore claimed at the hearing that she concluded that consolidation was not required under FIN 46(R) because VLC had enough equity to absorb any losses; that is, VLC was sufficiently capitalized because CCH Netherlands had contributed $500,000 to VLC as equity, which was in turn to be paid to Basin Water as the VLC I down payment. But as discussed above, Moore's conclusion as to VLC's capitalization—documented or not—was admittedly based solely on Basin Water management's uncorroborated assertions. No documents were obtained by the auditors evidencing VLC's equity structure or any contributions to VLC by CCH Netherlands, nor was evidence obtained about VLC's equity investors' ability to control VLC's activities or establishing its primary beneficiary.

Moreover, Moore does not dispute that, even if it were appropriate to conclude at the time of the VLC I transaction that FIN 46(R) did not require consolidation, that conclusion had to be revisited with the second VLC transaction. Yet she did not recall any FIN 46(R) analysis conducted specifically in connection with VLC II, for which management did not even prepare an accounting memorandum. Indeed, there is no evidence in the record that management or the auditors ever considered the question.

3. Moore Failed To Appropriately Evaluate Management's Conclusion that Recognition of Revenue for the WSS Transactions Was Appropriate.

Basin Water management asserted that collectibility of the WSS I sales price was reasonably assured because WSS was "backed by National City, a large Chicago Bank" and because $25,000 had been placed in escrow as an initial deposit against the $4,400,000 sales price. As with the VLC I transaction, Moore's agreement with management's reasoning and conclusion concerning collectibility was based solely on management's representations. Moore and the rest of the engagement team performed no procedures and obtained no evidence to corroborate management's assertions that National City had any relationship with WSS that might provide support for collectibility or that a $25,000 deposit had actually been placed in escrow. In addition, Moore conceded at the hearing that a $25,000 deposit on a $4.4 million transaction was not a sufficient basis for determining that collectibility was reasonably assured.

Moore did even less to evaluate the second WSS transaction than the first. The WSS II transaction occurred late in December 2007, just days before the end of the reporting period. Management prepared no memorandum to support its accounting for the transaction, but Moore understood that management's rationale for revenue recognition in the WSS II transaction was similar to its rationale in the WSS I transaction. Moore and others on the engagement team received the contract and a contract confirmation but performed no procedures to assess whether the collectibility of the $1.3 million sales price was reasonably assured, including any procedures to determine if National City actually backed the transaction.

4. Moore Failed To Appropriately Consider Whether the WSS Transactions Required WSS To Be Consolidated into Basin Water's Financial Statements Under FIN 46(R).

As with the VLC transactions, Moore needed to consider whether FIN 46(R) required WSS to be consolidated with Basin Water as a result of the WSS I transaction. She knew that WSS, like VLC, was a special purpose entity and was created specifically to enter into transactions with Basin Water and had no other operations. The WSS I transaction occurred near the end of the third quarter and involved a $4.4 million sales price (though the revenue would not be recognized all at once, but under the percentage-of-completion method). She also knew that under the terms of the transaction, WSS was obligated to pay only $25,000 up front plus an additional $1.5 million upon acceptance of the systems by the end user, with the balance payable beginning five years later. Thus, she knew that, as of year-end 2007, Basin Water was, in essence, financing 99.4% of the sales price and would continue to finance the sales price for ten years. There is no evidence that Moore considered whether the application of FIN 46(R) to the WSS I transaction required consolidation of Basin Water's financial statements with those of WSS. But to the extent Moore actually considered whether consolidation was required and concluded that it was not, her conclusion depended on Basin Water management's unsupported assertion that the SPE was sufficiently capitalized. No procedures were performed by the auditors to determine the capital structure of WSS or the economic relationships among the entities involved in the transaction, or even to confirm the participation of National City.

Moore testified that she understood that the WSS II transaction, occurring in late December and involving a $1.35 million sales price, also required her to consider whether consolidation was necessary. Yet, as she conceded, she did not perform such an analysis and was not aware of management performing one. Moore also admitted that she understood that the WSS II transaction was reason to cause her to reevaluate her prior conclusion about the WSS I transaction, and that she needed to consider whether WSS's capital structure had changed due to the WSS II transaction. Yet she testified that she obtained no evidence after the WSS II transaction about WSS's capital structure.

5. Moore's Defenses to the Charges Arising from the Audit Work on the SPE Transactions Lack Merit.

Moore makes several arguments in defense of the audit work on the SPE transactions. Although some of them appear focused only on the VLC I transaction, we broadly construe her arguments as defenses related to all of the SPE transactions. None of her arguments overcomes the evidence of violations.

a. Moore's Claim that Enough Audit Work Was Done To Address the Issue of Consolidation of Basin Water's Financial Statements with Those of VLC and WSS Is Refuted by the Evidence.

Moore claims enough was done in the audit with regard to the SPE transactions to satisfy applicable auditing standards. She points specifically to AICPA Practice Alert 2005-1, which provides guidance to auditors of nonissuers in planning and performing auditing procedures with respect to variable interest entities, and claims that the "audit team utilized this guidance in determining the procedures that we deemed, using our professional judgment, to be appropriate." MB 6. She asserts that the team "did send audit confirmations as part of our revenue and receivable audit procedures"; "did get and review the sales agreements noting significant provisions and assignment provisions in the related leases"; "did interview the Company's attorney related to [the] transaction (his opinion was that the sales were valid)" and "did call the managing member of the VIE entities for each transaction to discuss the nature of the transaction"; "researched the purported owners of the VIE entities on the internet and confirmed that the entity that was reported as providing the equity was in the business of underwriting/purchasing major equipment subject to leases such as Basin's"; "understood that the assets that were being sold generated sufficient funds to repay the notes receivable"; "discussed" the transactions with the audit committee; and believed the management-provided memorandum "covered the significant aspects of variable interests that Basin retained in the VIE." MB 6-8.

To begin with, although Moore seems to be implying in her brief that the team followed this guidance at the time of the audit, she specifically testified that she did not instruct her assistants to consult this practice alert in connection with the 2007 audit and that, to her knowledge, none of them did consult it. *See* Tr. 327-28. Moreover, her argument is inconsistent with the specific actions she claims were taken in the audit.

First, to the extent Moore claims to have carefully followed the guidance described in the practice alert, she departed from that guidance by admittedly neglecting to "review any operating agreements or other contracts to determine whether the nature and extent of such transactions create variable interests in VIEs." Ex. D-36 at 14. Although this guidance was incorporated into her own FIN 46(R) training materials, Moore testified that she failed to obtain any operating agreements related to VLC and WSS because "Basin [Water] wasn't a party to those operating agreements." Tr. 326-27. Regardless of whether Basin Water was a party to the operating agreements, however, Moore could not rely on Basin Water management's representations alone to conclude that (1) VLC and WSS were sufficiently capitalized to justify revenue recognition and (2) consolidation under FIN 46(R) was not required. That Basin Water was not a party to the operating agreements only makes her reliance on management's representations more unreasonable.

Second, Moore's mention of confirmations hurts, not helps, her defense, for, as discussed above, one of the confirmations for the VLC I transaction showed an obvious discrepancy of more than $500,000 yet was accepted as supporting management's accounting treatment for the transaction. Third, the letter agreement for the VLC II transaction was on its face incomplete as to the assets to be sold, indicating that Moore's review of the agreements could not have been as rigorous as she now claims. Fourth, discussion of the enforceability of the agreement with outside counsel occurred only with respect to the VLC I transaction and was irrelevant to collectibility and consolidation. Fifth, searching the internet to see if CCH Netherlands existed and engaged in certain types of business is not a substitute for determining if the bank was actually contributing the equity it supposedly promised, and there is no evidence that Moore did even that minimum amount of research with respect to the WSS transactions.

Sixth, there is no evidence to support Moore's claim that she or anyone else on the engagement team "called the managing member" (the Texas attorney behind the SPEs) during the 2007 audit. Seventh, to the extent Moore discussed the transactions with the audit committee, the import of those discussions is unknown and Moore does not offer specifics to support her argument.

Finally, although Moore claims that she believed the accounting memorandum provided to her by management covered the substance of a FIN 46(R) analysis, that memorandum did not contain the information necessary to a FIN 46(R) analysis, and it is clear that management did not share her belief: the company disclosed in its restated financial statements that it had not performed a FIN 46(R) analysis. Moreover, there is no accounting memorandum at all for the VLC II or WSS II transactions. In sum, the procedures that Moore claims were done in reference to Practice Alert 2005-1 were incomplete and did not corroborate the management representations that were Moore's basis for concluding that consolidation was not called for by FIN 46(R).

b. Moore's Claim that FIN 46(R) Audit Documentation Was Lost Is Unsupported, Inconsistent with Her Admissions that She Performed No FIN 46(R) Analysis with Respect to Two of the SPE Transactions, and Unavailing Because the FIN 46(R) Analysis Moore Claims To Have Performed Was Inadequate.

Moore contends that some of the audit documentation demonstrating the FIN 46(R) audit analyses was lost through a defect in the software used by SingerLewak. She asserts that the Basin Water electronic audit file **"**crashed and was restored several times during the audit. Restorations were performed with back-up copies and risk that work would be lost, despite efforts to review files, was significant." According to Moore, "Basin's audit file is missing documents, the extent of which is not entirely determinable given that it is impossible to have perfect recollection of the entire contents of the file. We do know that there is a standard Variable Interest Entity audit program (that existed in the Basin Water audit file under the prior repository system) that is not present as well as other summary documentation (i.e. our summary of waived adjustments)." MB 14.

Moore's claim of missing documentation that would have shown that she complied with PCAOB auditing standards is vague and contrary to the evidence. At the hearing, Moore acknowledged that if she had seen a FIN 46(R) analysis at the time of the 2007 audit she would have remembered it, and she remembered no such work paper. Tr. 249-50. Likewise, the engagement team's senior manager was unable to identify any relevant lost documents during the hearing and in fact, testified that any audit work that was lost in the transition to the new software system was, ultimately, redone. R.D. 47b at 500-01. And, significantly, management stated in its restated financials in 2008 that the SPE transactions were incorrectly accounted for "as a result of the failure to apply" FIN 46(R). If management conducted no FIN 46(R) analysis, Moore could not have evaluated one, and that is consistent with the lack of any evidence the engagement team conducted a FIN 46(R) analysis. Moreover, Moore's suggestion that the concepts necessary to form a conclusion as to consolidation were indirectly addressed in management's accounting memorandum discussing revenue recognition for the VLC I transaction supports the idea that, if Moore drew a conclusion that the SPEs did not need to be consolidated, she did not separately document it.

In an attempt to corroborate her claim that some documentation is missing from the audit work papers, Moore points to one document—a letter from CCH Netherlands confirming its obligations to VLC—that is referenced in a district court opinion in a pending SEC enforcement case against Basin Water's chief executive officer and chief financial officer, *SEC v. Jensen*, 2013 WL 6499699 (C.D. Cal. Dec. 10, 2013), appeal filed, No. 14-55221 (9th Cir. Feb. 7, 2014), but does not appear in the record before the Board. R.D. 59 at 1. In *Jensen*, the SEC alleged, in part, that the defendants improperly recognized revenue in connection with six transactions, including the four SPE transactions at issue here, to disguise the company's true financial performance in its 2006 and 2007 quarterly and annual reports, in violation of the antifraud provisions of the securities laws and related rules. The *Jensen* opinion only cursorily references the document cited by Moore, describing it as a "letter from CCH to VLC confirming binding agreement to pledge assets for CCH's purchase of units from Basin." 2013 WL 6499699, *18. The opinion does not explain how the court concluded it was "review[ed]" by SingerLewak during the 2007 quarterly reviews or audit, since no one from SingerLewak was called to testify at the trial of the Basin Water executives. Moore has acknowledged that the information she was provided during the SEC's investigation had all been included in the restatement work papers. Tr. 387-88.

Additionally, Moore testified that during the 2007 quarterly reviews and audit, she was not aware of any evidence of the relationship between CCH Netherlands and VLC. Tr. 138. Yet the letter she cites, at least as described by the district court opinion in *Jensen*, addresses that relationship. And the letter does so in such a way that, even if it had been given to the engagement team in the 2007 audit, only serves to raise unanswered questions. The document identifies the purchaser of the water treatment systems as CCH Netherlands, but by agreement VLC, not CCH Netherlands, was buying the systems from Basin Water.

Moore is thus unable to support her vague claim of lost audit documentation, which cannot overcome the extensive admissions, testimony, and stipulations in which she has conceded that she repeatedly accepted uncorroborated management representations about facts critical to deciding whether the SPEs' financial statements needed to be consolidated with Basin Water's. Tr. 123, 149-54, 250-51. Nor does it overcome Moore's admissions that she performed no FIN 46(R) analysis at all with respect to the VLC II and WSS II transactions, despite knowing these analyses were necessary. *See* Tr. 304, 319. We reject Moore's non-specific, unsupported claim that hypothetical lost work papers would show she performed a proper FIN 46(R) analysis.[11]

c. Moore's Claim that Management Withheld Information from the Auditors Is Unavailing.

Moore also argues that Basin Water management withheld information about the SPE transactions from the auditors. She asserts, "I believe that I conducted my audit in a professional manner and that circumstances outside of my (professional) control led to a restatement of the financial statements, an SEC trial and this PCAOB investigation." MB 2. According to Moore, "During the restatement process, management provided the audit team information that had not been provided during the original audit. Much of the information appeared to be information that management had in its possession, or should have had in its possession, an indication to us that management may have intentionally withheld information from the audit team that would have influenced our conclusion that the financial statements were (as originally filed) in accordance with Generally Accepted Accounting Principles." MB 3. Following the restatement an SEC investigation ensued, in which Moore was questioned. Moore testified that she saw materials in that context that indicated that "information had been kept from the audit team." But Moore could not clarify what she was referring to, and she acknowledged that the information she was provided at the SEC deposition had all been included in the restatement work papers. Tr. 387-88.

[11] Moore does not argue before us, as she did before the hearing officer, that the district court's decision (now on appeal) in favor of the defendants in the *Jensen* case has any bearing on the present case. In any event, the hearing officer correctly pointed out that *Jensen* features different charged parties and charges, distinct legal standards, and separate records. This proceeding seeks to determine whether Moore violated PCAOB standards in her conduct of the 2007 Basin Water audit in light of the specific circumstances presented to her as an auditor. That issue was not before the *Jensen* court, whose disposition of the case that was before it does not change the set of standards to which Moore was expected to adhere, eliminate the warning signs that are established by the record in this case, or mitigate her duty to exercise due care in light of them. *See, e.g., Hatfield,* 2013 SEC LEXIS 1954, *84 (noting that whether the issuers "ultimately filed materially misleading financial statements is not the issue" in that PCAOB case against the auditor); *cf. Michael J. Marrie*, SEC Rel. No. 34-48246, 2003 WL 21741785, *8 (July 29, 2003) ("An auditor who fails to audit properly…should not be shielded because the audited financial statements fortuitously are not materially misleading."), *rev'd on other grounds*, *Marrie v. SEC*, 374 F.3d 1196 (D.C. Cir. 2004).

The record shows that Moore asked for only one piece of information that management told her it did not have and could not obtain: VLC's operating agreement. Moore's response was simply to end her inquiry there. And any other information she lacked was due, according to her own testimony, to her failure to ask for it and her over-reliance on uncorroborated management assertions. Even assuming that Moore's characterization of management's interactions with her were accurate, such conduct did not relieve Moore of her responsibilities under PCAOB auditing standards. *See, e.g.,* AU § 326.25 ("To the extent the auditor remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion until he or she has obtained sufficient competent evidential matter to remove such substantial doubt, or the auditor must express a qualified opinion or a disclaimer of opinion."); *see also Hatfield*, 2013 SEC LEXIS 1954, *87 ("Whether the companies withheld documents or made misrepresentations…did not relieve Applicants of their auditing responsibilities"); *cf. John J. Aesoph, CPA,* SEC Rel. No. 34-78490, 2016 WL 4176930,*17 & n.86 (Aug. 5, 2016) (issuer's fraud "did not cause Respondents' auditing standards violations; those violations resulted from Respondents' failures to" comply with the standards); *Wendy McNeeley, CPA*, SEC Rel. No. 34-68431, 2012 SEC LEXIS, *40 (Dec. 13, 2012) ("The gravamen of the charge against [respondent] … is not her failure to uncover the fraud itself, but her failure to adhere to [applicable auditing standards] during the audit."); *Barry C. Scutillo*, SEC Rel. No. 34-48238, 2003 SEC LEXIS 1777, *24 (July 28, 2003) ("Scutillo cannot shift the blame for his actions to [management]. The fraud committed by [] management did not relieve him of his obligation to conduct a proper audit in accordance with established standards."); *Michael S. Hope, CPA*, SEC Rel. No. 34-23513A, 1986 SEC LEXIS 1041, *98 (Aug. 6, 1986) (stating that SEC has repeatedly held that "being lied to" is not an automatic defense to charges of improper professional conduct); *see also Ernst & Ernst*, SEC Rel. No. AS-248, 1978 SEC LEXIS 1451, *95 (May 31, 1978) ("That [the auditors] were deliberately deceived and that material information was kept from them is clear. But such deception did not relieve them of their responsibility to perform audits in conformity with [applicable] auditing standards.").[12/]

[12/] Moore's conduct of interim reviews of Basin Water's financial statements is not at issue in this proceeding, and we express no view on whether she satisfied the obligations applicable to those interim reviews. We note, however, that the standards applicable to interim reviews contain direction similar to that applicable to year-end audits with respect to an auditor's choices when confronted with management's refusal to provide information the auditor deems necessary. *See* AU § 722.28, *Interim Financial Information* ("When an accountant is unable to perform the procedures he or she considers necessary to achieve the objective of a review of interim financial information, or the client does not provide the accountant with the written representations the accountant believes are necessary, the review will be incomplete. An incomplete review is not an adequate basis for issuing a review report.").

B. Moore Violated PCAOB Auditing Standards in Evaluating Basin Water's Contract Loss Reserve Estimate.

It is undisputed that Basin Water's contract loss reserve was a significant accounting estimate identified by Moore as a risk of material misstatement because it was largely subjective and, as a result, could be manipulated by management. The fact that Basin Water had been sued by shareholders challenging the company's accounting for its contract loss reserves called even further attention to that estimate.

Moore was aware during the 2007 audit that management assumed that a possible future expansion of the water district's facility would cause the contract to break even beginning in 2009 and that therefore no loss reserve was necessary after 2008. Moore knew that management had revised its reserve estimate in the prior year because it had relied on ill-supported assumptions and instructed her audit assistants to devote specific attention to this account. Yet Moore took no steps to follow up with them to see if her instructions were followed and to discover if they had made any attempt to understand whether the estimate was reasonable or to corroborate the basis for it. Instead, Moore reviewed and approved the work paper that documented management's ill-supported basis for its estimate without further comment or action.

Moore contends that her evaluation of the reserve estimate was reasonable because she "determined that, based on the current positive cash flow and management's assertions that the cash flow would continue to be positive, that management's position that no additional reserve was required was appropriate." MB 9. There is no documentation in the work papers, as Moore admits, that the purported new profitability of the well at the end of 2007 was the actual basis for her conclusion that management's contract loss estimate was reasonable, nor any documentation showing that management itself considered this as a factor in its analysis. Thus, Moore's defense lacks support. *See Aesoph,* 2016 WL 4176930,*11 ("'if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done") (quoting AS No. 3 ¶ 6, App. A ¶ A10); *Dearlove*, 2008 SEC LEXIS 223, *32 n.39 (noting that "workpapers are ordinarily the foundation on which support for audit conclusions is demonstrated" and concluding that "[w]e consider the absence of work papers to be evidence that the audit team did not devote substantial, if any, effort to review the areas in question"); *Hatfield,* 2013 SEC LEXIS 1954, *43-46 (rejecting respondent's hearing testimony in which he claimed for the first time to have done a materiality assessment).

In addition, the schedule to which Moore points as support for the water district contract becoming profitable at the end of 2007 (Ex. D-147; Tr. 357-58) conflicts with the contract loss reserve schedule that showed an estimated loss for 2007 and 2008 (Ex. D-68 at 3, 157-58). If Moore had, in fact, relied on the former schedule during the audit, the record provides no explanation for why she failed to get clarification from management as to its reasons for recording a loss reserve for 2007 and 2008 when the water district contract had purportedly become profitable.

C. Summary of Findings of Violations

Based on the foregoing analysis, the Board finds that the Division proved by a preponderance of the evidence that Moore violated PCAOB Rules 3100 and 3200T by failing to comply with numerous PCAOB standards in the 2007 Basin Water audit.

Moore's evaluation of management's decisions to recognize revenue under SAB 104 for the four SPE transactions failed to comply with fundamental auditing standards. Moore was aware that revenue recognition generally, and the SPE transactions specifically, presented a high risk of material misstatement. *See Dearlove*, 2008 SEC LEXIS 223, *104 ("As audit risk increases, so does the need for care and skepticism."). She testified that she was concerned about whether these unusual transactions had economic substance and that she recognized that the transactions might even be detrimental to the company. And she was aware of gaps and discrepancies in the documentation with respect to, among other things, the company's receipt of down payments (such as evidence that Basin Water had not received its $500,000 down payment) and end-user consents, including evidence contradicting Basin Water's financial statement assertions about the revenue recorded for the SPE transactions.

Yet Moore admittedly accepted management's representations as the sole basis for her conclusions that (1) VLC and WSS were sufficiently capitalized to support collectibility under SAB 104; (2) the down payments had been received as promised in all four SPE transactions; and (3) the required consents from end users had been obtained and thus the deliverability factor of SAB 104 had been met for the VLC I transaction. Management representations are not a substitute for procedures designed to gather and evaluate evidence sufficient to support conclusions about financial statement assertions and afford a reasonable basis for an audit opinion. *Hatfield,* 2013 SEC LEXIS 1954, *6, n.10; *cf. Peat, Marwick, Mitchell & Co.*, SEC Rel. No. AS-173, 1975 SEC LEXIS 2516, *6 (July 2, 1975) ("While the Commission does not suggest that management representations are not a significant source of evidence, it is apparent that if the independent professionalism inherent in the auditor's role is to be maintained, evidence beyond these assertions must be obtained in significant audit areas.").

Under the circumstances, Moore thus violated (1) AU §§ 150 and 230 by failing to exercise due professional care, which requires observing the standards of field work, "diligently perform[ing]" the "gathering and objective evaluation of evidence," and exercising professional skepticism, "an attitude that includes a questioning mind and a critical assessment of the audit evidence," according to which the auditor "should not be satisfied with less than persuasive evidence because of a belief that management is honest"; (2) AU §§ 150 and 326 by failing to be "thorough" in her "search for evidential matter" and to obtain sufficient competent evidential matter to provide a reasonable basis for forming an audit opinion and to form conclusions regarding the validity of assertions in Basin Water's financial statements as to the revenue recorded for the SPE transactions; and (3) AU §§ 110, 316.66, and 316.67 by failing to consider whether management was "placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction" and whether the SPEs had "the substance or the financial strength to support the transaction," which Moore needed to do in order to understand whether management's business rationale for the "significant unusual" SPE transactions suggested "fraudulent financial reporting."

Moreover, Moore's disregard of clear discrepancies in the confirmation obtained for the VLC I note receivable was also a violation of her duty under AU §§ 330.15 and 330.33 to "evaluate the combined evidence provided by the confirmations…to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions." *See Marrie,* 2003 WL 21741785, *15 (finding failure to exercise appropriate professional skepticism and obtain sufficient evidential matter by failing to inquire further about confirmation discrepancies).

Moore also violated PCAOB standards in failing to conduct an adequate—or, as she admits for the VLC II and WSS II transactions, any—FIN 46(R) analysis of the SPE transactions. Her uncritical acceptance of management's representations as to the capitalization of VLC and WSS without obtaining corroborating evidence violated auditing standards requiring her to exercise due professional care and skepticism and to obtain sufficient competent evidential matter to form conclusions regarding the validity of assertions in Basin Water's financial statements as to the revenue recorded for the SPE transactions and to afford a reasonable basis for forming an audit opinion. AU §§ 150, 230, 326; *see McNeeley,* 2012 SEC LEXIS 3880, *43 (failing to follow up on unsupported and contradictory management representations was "a clear failure to exercise due care"). To the extent Moore performed any FIN 46(R) analysis, as she claims, she also violated AS No. 3, which requires an auditor to "document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions," because there is no evidence in the work papers that she conducted such an analysis.

Moore's work in the 2007 audit on the contract loss reserve estimate also fell far short of compliance with basic auditing standards. Moore knew the reserve presented a high risk of material misstatement. Thus, she needed to exercise increased care and skepticism in assessing the estimate. *See Dearlove,* 2008 SEC LEXIS 223, *104. Her acceptance of management's assumption about the future profitability of the water district well—concerned as she was about whether the assumption was adequately supported and about the history of the company having to correct its assumptions in prior years—constituted (1) a failure to exercise due professional care, including professional skepticism, in violation of AU §§ 150 and 230; (2) a failure to obtain and evaluate sufficient competent evidential matter to form conclusions regarding the validity of assertions in Basin Water's financial statements related to the contract loss reserve and to afford a reasonable basis for forming an audit opinion, in violation of AU §§ 150 and 326; and (3) a failure to obtain sufficient competent audit evidence that a significant accounting estimate was reasonable under the circumstances and was presented in conformity with applicable accounting principles, in violation of AU § 342.07.

Additionally, Moore's failure to follow up with her audit assistants after specifically instructing them to devote attention to the assumptions underlying the contract loss reserve was an abdication of her responsibilities to direct and review the work of her assistants "to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report," in violation of AU §§ 150, 311.11, and 311.13.[13/]

VI.

Sarbanes-Oxley Act Section 105(c)(4) authorizes the Board to impose "such disciplinary or remedial sanctions as it determines appropriate," subject to certain limitations, on registered public accounting firms or associated persons of such firms if the Board "finds, based on all of the facts and circumstances," that the firm or person has violated PCAOB rules and auditing standards. 15 U.S.C. 7215(c)(4). With respect to a proceeding against an associated person, such as here, Section 105(c)(5) specifies that a suspension, bar, or limitation on the activities or functions of such person, as well as a civil monetary penalty in excess of $110,000 "for each violation," "shall only apply" to "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard" or to "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." 15 U.S.C. 7215(c)(5); 17 C.F.R. 201.1003, Table III. In this

[13/] We need not reach the additional charge that Moore "improperly authorized the issuance by SingerLewak of a standard audit report expressing an unqualified opinion" on Basin Water's 2007 financial statements, in violation of AU § 150 (fourth standard of reporting) and AU § 508.07 ("The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with [GAAP]. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with [applicable] auditing standards."). This charge was not the subject of any particular discussion by the parties or the hearing officer. The violations we have found amply support our determination of sanctions, which follows.

context, recklessness "represents an 'extreme departure from the standards of ordinary care, … which presents a danger' to investors or the markets 'that is either known to the (actor) or is so obvious that the actor must have been aware of it.'" *Hatfield,* 2013 SEC LEXIS 1954, *77 (citation omitted). Applicable PCAOB auditing standards provide the standard of care for assessing the auditor's conduct. *Id*.

A. Moore Recklessly Violated PCAOB Auditing Standards.

In high-risk areas involving transactions with a substantial impact on the company's publicly reported revenue, Moore's conduct in leading the 2007 Basin Water audit fell far short of her responsibilities under basic auditing standards and constituted "an egregious refusal to investigate the doubtful and to see the obvious." *Marrie,* 2003 SEC LEXIS 1791, *54-*55 (cited in *Gately*, 2010 SEC LEXIS 2535, *39 & n.40); *see Hatfield*, 2013 SEC LEXIS 1954, *80. Moore acted recklessly, at investors' peril.

Moore determined that Basin Water had an "aggressive" approach to its accounting for revenue and knew that the SPE transactions were a significant change in Basin Water's business model that allowed the company to accelerate revenue recognition and avoid consolidation of its financial statements with those of the SPEs. She knew that the SPE transactions represented a substantial portion of Basin Water's revenues and permitted the company to avoid reporting a year-over-year decline in revenue. Jt. Stip. 3 ¶ 11.m. And she knew that management had, in the past, relied in estimating its contract loss reserve on what, in her judgment, were ill-supported assumptions that had to be corrected. Yet Moore knowingly relied uncritically, time and again, on management representations about the financial backing for the SPEs instead of obtaining and evaluating sufficient audit evidence, skipped basic audit procedures such as confirming that promised down payments and end-user consents were actually received, and failed to follow up with other engagement team members to confirm how management was supporting its estimate of the contract loss reserve. As the hearing officer found, Moore could not have failed to be "aware of a danger that Basin Water's financial statements were not accurate and that revenues were overstated." I.D. 81.

Where, as here, circumstances call for increased skepticism and the auditor nevertheless exercises little or none, that conduct is reckless. *See Scutillo*, 2003 SEC LEXIS, *25-26 (finding recklessness where auditor, "faced with a highly unusual transaction that accounted for more than half [the issuer's] assets" "conducted a perfunctory audit that, under the circumstances, was totally inadequate"). Moore must have known, for example, that relying on uncorroborated assertions about the participation and capitalization of entities central to several of the company's most novel and significant transactions presented a danger to those expecting its financial statements to "have been subjected to the rigors of independent and objective investigation and analysis" (*McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005)).

Moore was an experienced auditor who was a firm-designated specialist on revenue recognition and FIN 46(R), and she trained firm personnel on how to apply FIN 46(R).

Although Moore broadly claims that any violations in which she may have engaged do not "rise to the level of reckless" (R.D. 64 (Moore's Reply Brief, MBR) 3), this contention is at odds with our detailed and extensive examination of the evidence and findings of violations. Moore suggests, for example, that the overall complexity of the audit should mitigate a finding that her conduct was reckless. MB 12. As support, she asserts that Basin Water had completed a $12 million transaction in the fall of 2007 that "had to be analyzed for VIE implications too" and points to an accounting memorandum management prepared in March 2008 and provided to Moore, which concluded that the company was not required to consolidate the entity under FIN 46(R). *See* MB 12; Ex. GM-1; Tr. 110-12. The fact that Moore recognized the need to evaluate a management FIN 46(R) analysis for one transaction only highlights how egregious was her lack of such evaluation for the SPE transactions. And the violations found in this case do not turn on complicated interpretations or applications of governing principles but on flaws in carrying out basic audit tasks. In any event, complexity of an audit does not absolve an auditor of applying the required level of care. *Dearlove*, 2008 SEC LEXIS 223, *20, *78-79 (noting that auditing standards "apply to audits of all sizes and complexity" and rejecting argument that complexity excuses failure to observe obligations described by auditing standards). Moore has provided no basis for minimizing the nature or extent of her pronounced departures from the fundamental auditing principles at issue here.

B. Sanctions

In determining the sanctions that are appropriate for Moore's violations, we consider the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, to carry out our statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports. *See* Sarbanes-Oxley Act Section 101(a), 15 U.S.C. 7211(a); *see also* Section 101(c)(5), 15 U.S.C. 7211(c)(5) (in identifying duties of Board, referring to objective "to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof" or "otherwise to carry out this Act, in order to protect investors, or to further the public interest"); *Hatfield*, 2013 SEC LEXIS 1954, *95 ("'[T]he appropriate sanction depends upon the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings.'") (citation omitted). The gravity and extent of Moore's misconduct, under aggravating circumstances, outweigh the arguments offered in mitigation and call for the imposition of strong sanctions.

Moore's work in leading the 2007 Basin Water audit was severely deficient in multiple, important respects. She committed violations in two high-risk audit areas, involving four separate transactions and a reserve estimate for a fifth transaction, that required rigorous, objective audit inquiry and analysis and had a substantial impact on reported revenue. As the Division points out, "[b]y year-end, she had four different opportunities to audit the SPE transactions correctly," but "[e]ach time, she failed and, in fact, despite additional red flags, performed fewer procedures each successive transaction." R.D. 50, Division's Post-Hearing Brief 23. Her repeated lack of diligence in that audit work and failure to apply skepticism to management's representations, especially in light of the "surfeit of red flags" of which she was aware, betrays an approach to her audit responsibilities that was "perfunctory at best" (*McCurdy*, 396 F.3d at 1264) and created an "obvious, significant, and ongoing risk to investors" who were entitled to believe that the financial statements had been audited with due professional care (*Hatfield*, 2013 SEC LEXIS 1954, *85-*86). As the hearing officer concluded, Moore's violations were extensive, extreme, and "created a significant risk of harm to public investors and to the financial markets." I.D. 80, 81, 98. The more serious a violation, the stronger the inference that it will be repeated. *See generally Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004).

All the more troubling for our consideration of Moore's willingness and ability to comply with PCAOB auditing standards is the fact that she committed the violations despite being an experienced auditor, indeed a firm-designated specialist and trainer of other auditors in FIN 46(R), which should have helped equip her to understand her auditing responsibilities. *See, e.g., Hatfield,* 2013 SEC LEXIS 1954, *91 (imposing permanent bar on "experienced auditors, who nevertheless knowingly, intentionally, and repeatedly failed to exercise the basic professional skepticism and due care that are the touchstones of an auditor's responsibilities"); *Dearlove*, 2008 SEC LEXIS 223, *109, *111 (imposing a bar from appearing or practicing before the Commission with leave to reapply after four years for having "violated fundamental principles of auditing" despite "lengthy audit experience"). In her briefing to us, Moore represents, without elaboration, that she has "not participated as a partner on a public audit for several years." MB 21. But Moore's statements that she retains her CPA license in California (Tr. 16), intends to continue to work at a firm that audits issuers (MB 21), and is concerned that, if sanctioned, "I will lose all attest responsibilities (public and private because our practice is so interdependent)" (*id.*), as well as the fact that she is only about 50 years old (OIP 4 ¶ 11; Ans. 8 ¶ 11), indicate that at any time she could return to auditing public companies as a partner, if she has not already been doing so at a less senior level.

Moore may be accepting responsibility to some extent for her conduct when, at times in this proceeding, she suggests the possibility that "mistakes [were] made during the execution of the audit" and that "shortcomings [existed in] the efforts that we (the audit team) earnestly put forward." R.D. 64, Moore Reply Brief 2, 3. Although Moore has also stated that she was "mortified by the restatement and deeply troubled [by] the nature of the errors that were restated" and that, in addition to the "personal and professional price" she paid, "[t]he investors in Basin were also deeply affected" (R.D. 52, Moore Post Hearing Brief 13), those statements seem less an acceptance of responsibility for her own conduct than an expression of regret that errors were made by someone in a context in which there was a restatement. Overall, Moore's defense of her conduct leaves us with no assurance that she properly understands her auditing responsibilities and would respond appropriately if faced with similar circumstances in a future issuer audit. *See Hatfield*, 2013 SEC LEXIS 1954, *79-*80, *87, *92 ("That Applicants admit all of the facts forming the bases for their departures from professional standards without grasping the extent of their wrongdoing raises serious questions about their ability to comply with those standards in the future."); *see generally, e.g., Aesoph,* 2016 WL 4176930, *17 & n.81 (citing *Seghers v. SEC*, 548 F.3d 129, 136-37 (D.C. Cir. 2008)); *Horning v. SEC*, 570 F.3d 337, 346 (D.C. Cir. 2009); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 100 (2d Cir. 1978); *Rita J. McConville*, SEC Rel. No. 34-51950, 2005 SEC LEXIS 1538 at *60 (June 30, 2005), *aff'd*, 465 F.3d 780 (7th Cir. 2006).

Additionally, Moore argues that she should not be sanctioned in this case because she has "never been subjected to any professional sanctions" and because Basin Water's 2006 audit was "subject to [PCAOB] inspection and received no comments," and two 2009 audits unrelated to Basin Water received just one comment after PCAOB inspection. MB 21. Moore does not explain how inspection of some audit work that predated the significant changes to Basin Water's business model or of later audit work done for unrelated companies is relevant to our assessment of the deeply and extensively flawed work she did on the 2007 Basin Water audit, about which we have ample, detailed, and direct evidence. Moreover, we cannot agree with Moore that her argument about unrelated audit work is entitled to significant weight, as she is obligated to comply with PCAOB rules and standards at all times as an associated person of a registered public accounting firm. *E.g.,* PCAOB Rules 3100, 3200T; *see generally, e.g., Siegel v. SEC*, 592 F.3d 147, 156-57 (D.C. Cir. 2010); *Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006).

Moore further contends that sanctions are unnecessary because, according to her brief, she has "already paid a significant personal and professional price" as a consequence of this proceeding, in that she has "not participated as a partner on a public audit for several years" and her "compensation and [her] role as a partner has been deeply affected by this matter." MB 21. These asserted effects do not diminish the Board's imperative to "protect the interests of investors and further the public interest" by, among other things, investigating and sanctioning conduct that threatens those interests. *See* 15 U.S.C. 7211(a), 7211(c)(5); *see also Gary M. Kornman*, SEC Rel. No. 34-59403, 2009 WL 367635, *9 (Feb. 13, 2009) (concluding that "'[f]inancial loss to a wrongdoer as a result of his wrongdoing' does not mitigate the gravity of his conduct") (quoting *Robert L. Wallace*, SEC Rel. No. 34-40654, 1998 WL 778608, *5 (Nov. 10, 1998)), *aff'd*, 592 F.3d 173 (D.C. Cir. 2010); *Hunter v. SEC*, 879 F. Supp. 494, 501 (E.D. Pa. 1995) (there is no general right "not to be injured in one's reputation or business prospects" by the fact of investigative or disciplinary actions that are authorized by Congress) (citing cases).

Finally, Moore contends that she should not be sanctioned because she has been "forthcoming and cooperative with PCAOB inquiries and requests" and has "the u[t]most respect for the PCAOB's mission." MB 22. PCAOB policy regarding how extraordinary cooperation may be considered in connection with an investigation does permit the extension of some credit for such cooperation under certain circumstances but would not apply to efforts that are not "beyond what is required to comply with legal and regulatory obligations." *Policy Statement Regarding Credit for Extraordinary Cooperation in Connection with Board Investigations*, PCAOB Rel. No. 2013-003 (Apr. 24, 2013) at 1, 4. Moore fails to identify any conduct that rises to a level above what is expected of all persons who elect to register with the PCAOB. *Cf. Kent M. Houston*, SEC Rel. No. 34-71589A, 2014 WL 936398, *7 & n.56 (Feb. 20, 2014) (citing *Philippe N. Keyes*, SEC Rel. No. 34-54723, 2006 WL 3313843, *6 n.22 (Nov. 8, 2006) (applicant's "cooperation in the [FINRA] investigation was consistent with the responsibilities he agreed to when he became an associated person and does not constitute substantial assistance" and therefore mitigative credit under FINRA Sanction Guidelines)); *see* PCAOB Rules 5110(a), 5200(a)(3). And it hampers her attempt to claim credit for forthrightness in acknowledging facts during the litigation to at the same time refuse to accept responsibility for auditing standards violations established by those facts, standards it is the PCAOB's mission to enforce.

Based on consideration of all of the facts and circumstances of this case, we find that Moore poses a substantial, continuing risk of harm to those who trust to the reliability of issuer audit reports. Accordingly, we bar Moore from association with a registered public accounting firm. *See Dearlove*, 2008 SEC LEXIS 223, *111 & n.120 (citing certain litigated SEC Rule 102(e) cases against auditors involving violations in a single audit); *Aesoph*, 2016 WL 4176930, *17 (Rule 102(e) case sanctioning auditor based on violations in one audit). The Division has not urged that Moore be permanently barred (nor has the Division requested that we impose a civil money penalty). But because Moore's conduct was particularly incompatible with her role as the auditor with final responsibility for the audit, while we provide that she may petition the Board to associate with a registered public accounting firm after two years,[14/] we

[14/] In considering any such petition, the Board will assess all of the factors described in PCAOB Rule 5302(b) and, among other things, will give weight to whether, since the effective date of the order accompanying this final decision, Moore has completed a have additionally determined to limit her activities by restricting her for a further two years from serving as an engagement partner or an engagement quality reviewer on issuer audit engagements, or from exercising authority either to sign a registered public accounting firm's name to an audit report for any issuer or to consent to an issuer's use of a previously issued audit report. These measures will serve the purpose of encouraging more rigorous compliance with PCAOB auditing standards by Moore and other auditors. To further impress on Moore the egregiousness of her violations and the seriousness of her auditing responsibilities, we also censure her. This sanction additionally serves the public interest by "notif[ying] the public of [Moore's] past misconduct" even after the terms of the other sanctions have been fulfilled. *Salvatore F. Sodano*, SEC Rel. No. 34-59141, 2008 WL 5328801, *3 (Dec. 22, 2008). We believe that together these sanctions protect investors and further the public interest, and none of Moore's arguments, and none of the circumstances presented by this case, suggest to us that the sanctions are in any way excessive or oppressive. *See* 15 U.S.C. 7217(c)(3).[15/]

VII.

As set forth above, we have found that the Division proved by a preponderance of the evidence that Moore violated PCAOB rules and auditing standards, and we have determined appropriate sanctions for those violations.

An appropriate order will issue.[16/]

By the Board.

combined total of 50 hours of professional education directly related to revenue recognition, financial statement consolidation, management estimates, and professional skepticism.

[15/] Even if Moore had not acted recklessly, she engaged, at the very least, in repeated instances of negligent conduct, and the instances were sufficiently numerous and serious to warrant the sanctions we impose. 15 U.S.C. 7215(c)(4), (c)(5)(B); *Hatfield*, 2013 SEC LEXIS 1954, *97 n.169 ("given the scope of [the auditor's] repeated auditing failures" finding that sanctions were appropriate "regardless of whether [the auditor's] conduct is deemed to be knowing, reckless, or negligent").

[16/] We have considered all of the parties' contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Gale Moore, CPA, Respondent	PCAOB File No. 105-2012-004 **ORDER IMPOSING SANCTIONS** August 23, 2016

On the basis of the Board's opinion issued this day it is

ORDERED that Gale Moore is censured; and it is further

ORDERED that Gale Moore is barred from associating with any registered public accounting firm, provided that, after two (2) years, she may petition for Board consent to associate with a registered public accounting firm[1/]; and it is further

ORDERED that, if Gale Moore is permitted to associate once again with a registered public accounting firm, she may not, until after four (4) years from the effective date of this order, serve on any audit with respect to an issuer in the role of "engagement partner," as that term is defined in PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement*, or in the role of "engagement quality reviewer," as that term is used in PCAOB Auditing Standard No. 7, *Engagement Quality Review*, or exercise authority either to sign a registered public accounting firm's name to an audit report for an issuer or to consent to an issuer's use of a previously issued audit report.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for

[1/] In considering any such petition, the Board will assess all of the factors described in PCAOB Rule 5302(b) and, among other things, will give weight to whether, since the effective date of this order, Moore has completed a combined total of 50 hours of professional education directly related to revenue recognition, financial statement consolidation, management estimates, and professional skepticism.

Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the date the Commission lifts the stay imposed by Sarbanes-Oxley Act Section 105(e), 15 U.S.C. 7215(e).

By the Board.

Phoebe W. Brown
Secretary

August 23, 2016

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PCAOB
Public Company Accounting Oversight Board

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Kabani & Co., Inc., Hamid Kabani, CPA, Michael Deutchman, CPA, and Karim Khan Muhammad, CPA, Respondents	PCAOB File No. 105-2012-002 **ORDER SUMMARILY AFFIRMING FINDINGS OF CERTAIN VIOLATIONS AND IMPOSITION OF SANCTIONS FOR THOSE VIOLATIONS** January 22, 2015

I. Introduction

On April 22, 2014, the hearing officer issued an amended initial decision in this disciplinary proceeding, finding that the registered public accounting firm Kabani & Co., Inc., and three associated persons of the firm, Hamid Kabani, Michael Deutchman, and Karim Khan Muhammad, participated in a "wide-spread and resource-intensive effort" over several weeks in 2008 to alter documents in the audit files of three issuers in an attempt "to deceive PCAOB inspectors in an upcoming inspection about the deficiencies in the Firm's audit work papers." The decision found that Kabani's and Deutchman's misconduct was "intentional and knowing," and Khan's was "knowing, intentional, or at least reckless." The decision concluded that respondents thereby violated PCAOB Rule 4006, which requires public accounting firms and associated persons to cooperate with Board inspections, and PCAOB Rule 3100, which requires such firms and their associated persons to comply with applicable auditing standards. Here, the applicable auditing standard with which respondents failed to comply is Auditing Standard (AS) No. 3, which requires that a complete and final set of audit documentation should be assembled for retention within 45 days after the audit report release date.

For these violations of Board rules and standards, the decision imposed certain sanctions. Specifically, it revoked the firm's registration; permanently barred Kabani from associating with a registered public accounting firm and ordered him to pay a $100,000 civil money penalty; barred Deutchman from associating with such a firm, with leave to petition the Board to associate in two years, and ordered him to pay a $35,000 civil money penalty; barred Khan from associating with such a firm, with leave to petition to associate in 18 months, and ordered him to pay a $20,000 civil money penalty; and censured all four respondents.

On May 23, 2014, Kabani, the firm, and Deutchman (identifying themselves as the "Kabani Respondents") together filed a petition for review of the amended initial decision. On May 27, 2014, Khan, unrepresented by counsel, also filed a petition for review. The parties have also filed various motions related to the petitions for review.

In one of those motions, filed on May 30, 2014, the Division of Enforcement and Investigations (Division) requested that we "expedite review" and allow the Division to supplement the record with publicly available information about ongoing audit work by the firm since the issuance of the Order Instituting Disciplinary Proceedings in this case on June 15, 2012. The Division asserted that this information, gathered from Securities and Exchange Commission filings by issuers disclosing audit fees they paid to Kabani & Co., demonstrates that the firm has continued to perform auditing work for public companies through 2014. The Division argued that the respondents, whose sanctions are automatically stayed pending their appeal, therefore pose a "significant risk to investors." It further argued that "[t]he evidence [against the respondents] is so extensive and unequivocal, and the Petitions for Review so patently meritless, that it is difficult to conclude that the Petitions have been filed for any purpose other than to delay sanctions and public revelation of [their] improper conduct." The Kabani Respondents opposed the motion to expedite, summarizing their exceptions to the amended initial decision and asserting that "[e]xpediting review—and hence forcing a more rushed, inherently less thorough and careful review—only compounds the mistakes that should now be corrected." Khan similarly opposed the motion.

On June 24, 2014, the Board issued an order extending the time for setting a briefing schedule pursuant to Board Rule 5462(a)(2), in order to consider the pending motions as well as to consider whether the initial decision or any portion of it would be appropriate for summary affirmance under Board Rule 5460(e). It is well established that summary affirmance can be an appropriate method of resolving administrative proceedings. *See, e.g.*, *Yuk v. Ashcroft*, 355 F.3d 1222, 1232 (10th Cir. 2004) (holding that "[d]ue process and principles of administrative law require nothing more" from an agency than providing respondents with "a meaningful and thorough review of their claims, and, in the [initial] decision, ... a reasoned explanation for the agency's decision, which [the court] can, in turn, review"); *Albathani v. INS*, 318 F.3d 365, 379 (1st Cir. 2003) (rejecting challenge to agency's use of summary affirmance and noting that "[c]ourts themselves use 'summary affirmance' or 'summary disposition' procedures" as "workload management devices"); *MBH Commodity Advisors v. CFTC*, 250 F.3d 1052 (7th Cir. 2001) (affirming CFTC's order of summary affirmance); *Cities of Bethany v. FERC*, 727 F.2d 1131 (D.C. Cir. 1984) (affirming such order by FERC).

Board Rule 5460(e) provides that we may summarily affirm an initial decision if "no issue raised in the petition for review warrants further consideration by the Board." Courts have found that, where the arguments raised on appeal "do[ ] not present any substantial reason to doubt the soundness" of the opinion below or where they "are so lacking in merit" that a full discussion of them is not warranted, it may be appropriate to summarily affirm all or part of that decision. *E.g., Brown v. Eppler*, 725 F.3d 1221, 1228 (10th Cir. 2013) (reversing district court's grant of summary judgment as to certain claims but summarily affirming remaining contentions without discussion); *In re Leventhal*, 2013 U.S. App. LEXIS 4767 (7th Cir. 2013) (summarily affirming findings of bankruptcy judge, and district judge who affirmed those findings).

Having reviewed the respondents' petitions for review and conducted a de novo review of the record, we conclude, as discussed below, that no issue raised in the petitions for review regarding the Rule 4006, AS No. 3, and resulting Rule 3100 violations found in the initial decision warrants further consideration by the Board. This case does not raise subtle questions about the interpretation or application of complex auditing rules. Rather, the central issue is whether or not respondents altered final audit files after the deadline for completing them had passed. Respondents spend the great majority of their petitions challenging the hearing officer's findings of fact, but our review showed the amended initial decision's presentation of the facts to be fairly based on a preponderance of the record evidence. *See* Board Rule 5204(a); *S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 SEC LEXIS 1954 at *4 (July 3, 2013) (applying preponderance standard to review of PCAOB disciplinary proceeding).

In deciding that respondents had, in fact, engaged in a scheme to alter those files well after the relevant deadlines, the hearing officer marshaled several different sources of evidence in support of the findings of fact that underpin his findings of violation. That evidence includes parties' stipulations, investigative and hearing testimony, emails sent among firm employees in the months and weeks before the PCAOB inspection, audit work paper files, and a comprehensive expert report and related expert testimony. That evidence demonstrates a course of misconduct—including intentionally resetting computer clocks to make documents appear to have been finalized before operative deadlines—that is troubling on its face. But the changing, conflicting, and patently incredible explanations for these document alterations offered by respondents throughout this proceeding accentuate the gravity of the misconduct and underscore how meritless respondents' arguments to the contrary now are.

For the reasons discussed below, we summarily affirm, pursuant to Board Rule 5460(e), the amended initial decision's findings of those violations and its imposition of sanctions for those violations.

II. Summary of Amended Initial Decision's Findings of Violation

As detailed in the amended initial decision, Kabani & Co. is a small firm, employing about 20 people in an office in Los Angeles that comprises less than 2,000 square feet. At all relevant times, Kabani, Deutchman, and Khan were persons associated with that registered public accounting firm, as defined by Section 2(a)(9) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201(9), and PCAOB rules. Kabani and Deutchman were the firm's only two partners. Kabani was informed in June 2008 that PCAOB inspectors would be conducting an inspection of the firm's audits; in July 2008 PCAOB inspectors notified him of the date the inspection would begin (October 20, 2008). In or around June 2008, Kabani held a staff meeting attended by, among others, Deutchman, Khan, and Rehan Saeed, an independent contractor who usually worked remotely and served as a concurring reviewer for some of the firm's audits. At the meeting, Kabani informed the group about the upcoming inspection. He explained that PCAOB inspectors had identified deficiencies in the firm's files on previous visits and that he wanted certain audit files reviewed in advance for deficiencies. He also explained that PCAOB rules permitted the firm to correct certain deficiencies and that Saeed would review some audit files to identify any missing documentation. Deutchman testified during the investigation that "[e]verybody was afraid of the inspection. Everybody was terrified of the PCAOB, almost paranoid of the PCAOB…." The firm's employee time records show that the file reviews completed in preparation for the inspection would consume a substantial amount of time, so much so that, as Saeed testified, the firm "couldn't do much billing" on other work.

Shortly after the staff meeting, Kabani gave Saeed a list of files to review and a checklist to use in reviewing the files for completeness. When the PCAOB inspectors disclosed to Kabani the list of companies whose audit files they would be reviewing during their site visit, Kabani forwarded that list to Saeed and instructed him to focus his efforts on those companies in which the PCAOB was interested. In several emails sent contemporaneously by a junior staff member, tasked with helping to manage the review, the effort is variously referred to as "PCAOB Cleanup" and "Rehan's PCAOB Cleaning-up." Kabani, Deutchman, and Khan are copied on nearly all of these emails and had significant responsibility for the audits being reviewed: of the three audits at issue in this proceeding, Kabani served as engagement partner for all three, Deutchman served as the concurring partner on all three, and Khan was the auditor "in-charge" for one. Yet they deny having any understanding of what "PCAOB Cleanup" meant. Khan, incredibly, testified that it was unclear whether the junior staff member "was asking PCAOB to clean something" and that it "looks like PCAOB is cleaning something."

In September and October 2008, Saeed reviewed the audit files of the companies Kabani chose; those files were electronic (most of which were in Microsoft Word, Microsoft Excel, or Adobe PDF file format) and were organized using software called Engagement Manager. Central to this case are the three files documenting the firm's audits of three issuers, as defined by Sarbanes-Oxley Act Section 2(a)(7), 15 U.S.C. 7201(7)—Issuer A, Issuer B, and Issuer C—for the year ended December 31, 2007. In September and October 2008, Saeed reported to Kabani, Deutchman, and Khan that the files were incomplete and contained other deficiencies such as missing signatures on management representation letters and trial balances that did not agree. Email correspondence from staff assisting with the review shows the audit files were then "updated" to address Saeed's comments. AS No. 3 permits additions to be made to final audit files, but only if the person adding the information documents his or her name, the date of the addition, and the reason for doing so. The respondents made no such notations and gave the modified files to the PCAOB inspectors in October 2008.

Saeed stopped working with the firm in September 2009. Thereafter, he contacted the PCAOB to share concerns that he had about the firm's activities leading up to the 2008 inspection, and he provided documents to the Board that included emails and electronic copies of audit work papers that he had in his possession from the review Kabani had asked him to conduct. In response to Accounting Board Demands issued by the Board, the firm also produced copies of, among other things, audit files for the 2007 audits of Issuer A, Issuer B, and Issuer C. Those audit files were the same as, or a substantially identical backup copy of, the files given to PCAOB inspectors in October 2008. Saeed was charged with misconduct in this proceeding but made an offer of settlement to the Board, which we accepted on May 21, 2013. *See* Order Making Findings and Imposing Sanctions in the Matter of Rehan Saeed, CPA, PCAOB Rel. No. 105-2013-004 (May 21, 2013), *available at* http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx.

A basic comparison of the versions of the audit files Saeed reviewed with the versions the firm provided to the Division in 2011, in response to the Accounting Board Demands, reveals some patent changes that were made to the final audit files after the document completion deadlines had passed. For example, in respondents' version of the Issuer A audit file, 41 work papers reflecting lead schedules or trial balances are facially different from Saeed's versions, the later of the two reflecting the resolution of earlier notations indicating further work needed to be done. As another example, respondents' version of the Issuer B file contained a management representation letter bearing a different date and containing substantially different representations than the analogous letter found in Saeed's version of the file.

But many more post-deadline changes became obvious upon forensic examination of the files. A computer data forensics expert retained by the Division explained, in his comprehensive report and in testimony, that computer documents contain metadata—i.e., information about the document itself, such as when and by whom it was created and last modified—that is preserved as part of the document and available for forensic examination. The metadata in the electronic audit files produced by the firm shows that many documents were created and/or changed well after the document completion deadlines had passed. But the metadata also manifests a pattern of anomalous creation and modification dates—that is, many documents in each of the three audit files appear to have been created *after* they were last modified—which is impossible without someone or something acting on the computer's internal clock. The Division's expert explained that the evidence in this case demonstrates that each of these anomalous documents was probably opened on a computer whose clock had been intentionally set backward; then the user (including one or more persons variously logged in as "Hamid," "Kabani," "Hamid Kabani," "Karim," and "Mohammed") made some change to the document (sometimes a nearly invisible change, such as adding a carriage return after the last line in a field of text), and then saved the file, making it appear superficially that the document was older than it actually was. Documents in all three audit files produced by respondents bore unmistakable signs of having been intentionally backdated so that they seemed to comply with the applicable documentation completion deadlines in AS No. 3 when in fact they did not.

The hearing officer found that the expert's "methodologies were reasonable; his findings were detailed and meticulous; and his conclusions were well-reasoned and well-supported." Amended Initial Decision (I.D.) 26. He also noted that "[r]espondents were not able to undermine the validity of, or raise serious questions about, his findings and opinions." I.D. 27. The hearing officer accepted the expert's findings and conclusions, noting that they were "consistent with the email communications and Saeed's testimony evidencing a plan to alter the audit work papers in anticipation of the PCAOB inspection." I.D. 26. After considering and rejecting the arguments offered in defense by the respondents, the hearing officer concluded that "the Firm failed to cooperate with the PCAOB inspection by providing the inspectors with work papers for several audits that had been improperly altered after the deadline for completing the audit documentation" and that "Kabani, Deutchman, and Khan participated in the scheme to alter the work papers and to provide the altered work papers to the inspectors." I.D. 48.

III. Respondents Raise No Meritorious Arguments on Review

Most of the exceptions taken by the respondents to the amended initial decision consist of arguments that have already been aired before the hearing officer and were addressed in the decision itself. The petitions for review and the related motions practice have not identified any potentially meritorious challenges to the hearing officer's findings of violation of Rule 4006, AS No. 3, and consequently Rule 3100.

A. Arguments about the metadata and the state of the audit files

Before the hearing officer and now before the Board, respondents have made several principal arguments. First, they have offered a number of different explanations for why the metadata evidence did not necessarily demonstrate intentional misconduct. Their arguments ranged from conflicting to unsupported to implausible. For example, the respondents, at different times, suggested, among other things, that a software failure caused the anomalies, that the innocent act of importing already-existing files into the Engagement Manager program caused the modification dates to change, and even that perhaps any intentional resetting of the company's computer clocks might have been done to circumvent the time limitations in the temporary license agreement accompanying the trial version of a hypothetical software product. The hearing officer found nothing in these arguments sufficient to undermine the thorough, specific, and well-supported testimony of the Division's expert. Nor do we.

Second, respondents have contended that, evidence of backdating and late addition of documents aside, the copies of the audit files supplied to the Division cannot be relied upon to prove liability. They have argued variously that the files they provided to Saeed to review were not final files but were incomplete drafts to be reviewed as part of an internal inspection; that the files Saeed reviewed were not final and were merely being used to train junior staff members on how to conduct an audit; that the Issuer A file they provided to the Division was not the final version of the file given to inspectors because the real file was irretrievable; and that the electronic files in Engagement Manager were merely part of a larger collection of final audit files that included some unidentified (and unproduced) bank of hard copy files.[1/] As the hearing officer explained, these assertions are at odds with the evidence in this case, most notably with the testimony given by respondents themselves during the investigation that often squarely contradicted their assertions at the hearing and which respondents have offered no way to reconcile. For example, in investigative testimony given just days after he had produced the Issuer A file to the Division, Kabani twice told investigators

[1/] The Kabani Respondents broadly argue that "[s]canning existing hard-copy documents (that are already part of the final set of work papers in a manila file) and putting them with electronic files does nothing to change the final set of audit work papers" and is not, therefore, a violation of AS No. 3 even if no notation is made to explain the addition. *See, e.g.*, Kabani Respondents' Corrected Post-Hearing Brief at 67; Kabani Respondents' Petition at 22; *see also* I.D. at 64, 69. We need not reach that issue because it is moot, given the specific facts of this case that show, for example, that the version of the files Saeed reviewed—which did not include any hard copy documents—were the final files, that at least one of the scanned files was intentionally backdated, and that there is no credible evidence proving the existence of the dual audit file system the respondents describe.

that the audit files he had produced to the Board in response to the Accounting Board Demands were exactly the same as those given to the PCAOB inspectors in 2008. The amended initial decision identifies many other similar instances demonstrating how respondents' testimony regarding the finality of the files being reviewed by Saeed and of the files produced to the Division was self-contradictory and how their "version of events defied the plain sense meaning" of the evidence. I.D. 50-58.

Third, respondents also object that the hearing officer's decision does not take into account how difficult it would be to manufacture the work papers that were supposedly missing from the deficient files. The version of the Issuer A file produced to the Division in 2011, which they cite as an example, contains over 900 documents that did not appear in the file reviewed by Saeed in 2008. Respondents suggest that, therefore, Saeed could not have been reviewing the final version of the Issuer A file in 2008 to help Kabani & Co. correct it, because it would have been impossible to correct that magnitude of deficiency by creating 900 work papers in less than two months. First, there has been no allegation that respondents created 900 work papers from whole cloth. Moving already extant work papers for several of Issuer A's subsidiaries into a complete file could have easily accounted for the additions in the time taken for the "PCAOB Cleanup" and is consistent with the evidence. *See* I.D. 30-31 & nn.180-81. The Division's expert estimated that the updates to the computer files he reviewed could likely have been completed within "a month or two." This would still have violated AS No. 3 because the fact of, and reason for, these post-deadline assembly activities were not recorded in the file. But, second, it is unnecessary to determine precisely how these 900 new documents came to reside in the file Kabani provided to the PCAOB. For even if we make no comparison between the two versions of the audit file and instead look only at Kabani's version, that file alone bears evidence of late-added files and intentional backdating that is more than sufficient to sustain a finding that respondents failed to cooperate with the PCAOB inspection. *See* I.D. 29-30; Hearing Exhibit D-220 at 21-22. We find no basis to credit respondents' arguments.

B. Credibility issues

Many of the respondents' exceptions in their petitions for review are based on an assertion that the hearing officer wrongly failed to credit their testimony and instead credited contrary testimony by Rehan Saeed, whom the respondents have characterized as a disgruntled ex-employee of Kabani & Co. who had a motive to testify falsely against the respondents because Kabani did not grant Saeed full partnership at the firm. They also argue that, because Saeed admitted to altering a document that he filed with the PCAOB in support of his answer, Saeed's testimony is generally unreliable. The hearing officer satisfactorily addressed these issues in his decision, however, concluding that, although he was "not without concerns regarding Saeed's conduct and motives," he nonetheless "found [Saeed] credible on the major aspects of his testimony." I.D. 54. The hearing officer explained at length the bases for his conclusion, including that Saeed's testimony "on the key issues in this case was corroborated substantially by both the Firm's contemporaneous email traffic as well as the metadata in the audit work papers"; that Saeed took a professional risk in coming forward with his concerns about misconduct at the Firm; and that Saeed's testimony on key issues was "consistent" and not effectively challenged by respondents. I.D. 54-55. The hearing officer also explained in detail why he found that respondents, on the other hand, "were often not credible on issues pertaining to work paper alterations." I.D. 55. The decision describes respondents' professed inability to recall important events, contradictions in their responses to questions asked during investigative and hearing testimony, and wholesale attempts to distance themselves from evidence against them, as when Khan professed at the hearing to have "no independent recollection" of whether the responses in the answer he filed were accurate. I.D. 55-57.

Respondents have provided no basis for revisiting the hearing officer's credibility determinations, and the record provides ample basis for declining to do so. Indeed, respondents' continued attempts to distance themselves from the damaging testimony they gave during the investigation only underscore the validity of the hearing officer's conclusions. For example, the Kabani Respondents suggest in their petition for review that their investigative testimony should not be relied upon because the Division failed to "disclos[e] what charges was Kabani under the investigation so they could have prepared and explained three years old items" [sic]. An investigation—by definition a fact-finding exercise—necessarily precedes the institution of formal enforcement proceedings, which cannot be brought until the Board is satisfied that, "as the result of an investigation or otherwise," a hearing is warranted to determine whether a person subject to our jurisdiction has violated a professional standard, rule, or law. Board Rule 5200(a)(1). And, as pointed out by the hearing officer in his decision, the very fact that investigative testimony is given before a respondent knows how to discern the import of that testimony gives it particular value. I.D. 50.

Our conclusion is not altered by the Kabani Respondents' attempt on review to introduce new evidence regarding Kabani's truthfulness. The Kabani Respondents have filed a motion to supplement the record with the results of a lie-detector test administered to Kabani in May 2014, after the amended initial decision was issued. The Kabani Respondents claim that the polygraph exam results serve as "corroboration that they have told the truth" and prove that the amended initial decision "is wrong."

PCAOB Rule 5464 permits parties to file motions to adduce additional evidence prior to issuance of a Board decision but requires that "such motion shall show with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously." The Kabani Respondents have not addressed this rule and have offered no explanation for their failure to offer polygraph evidence in proceedings before the hearing officer. They were represented by counsel during the six-day hearing, at which time they were given a full opportunity to present evidence, call and question witnesses, and vigorously mount a defense. In their motion, the Kabani Respondents note that Kabani was "so shocked by this the [sic] Hearing Officer's finding's [sic] in the Amended Initial Decision" that he submitted to the test, but, to the extent Kabani's surprise is offered as an explanation for why Kabani did not submit to a polygraph test before the hearing, it is not adequate. Witness credibility is an issue to be considered in nearly every adjudicated proceeding, as is the possibility of an unfavorable decision. A respondent cannot wait for an unfavorable decision before adducing material evidence. *See Gross v. SEC*, 418 F.2d 103, 108 (2d Cir. 1969) (upholding SEC's decision to reject respondent's bid to reopen hearing and testify on his own behalf where "[t]he only ground asserted for [respondent's] failure to testify [earlier] is the judgment of counsel at the time of the original hearings, which petitioner's present counsel has now concluded was unwise"), *citing with approval David T. Fleischman*, SEC Rel. No. 34-8187, 1967 SEC LEXIS 560 at *8 (Nov. 1, 1967) ("Public policy considerations favor the expeditious disposition of litigation, and a respondent cannot be permitted to gamble on one course of action and, upon an unfavorable decision, to try another course of action."); *Ralph W. LeBlanc*, SEC Rel. No. 34-48254, 2003 SEC LEXIS 1793 at *19 n.20 (July 30, 2003) (denying motion to adduce additional evidence where respondent "rationalize[d] the lateness of the submission on the ground that the significance of the materials was not made clear to him until the law judge rendered a decision that was plainly unfair to him").

Even if the tardiness of Kabani's effort to bolster his credibility could be ignored, he has failed to demonstrate that the test results are material to this case. Without citation to any supporting authority, the Kabani Respondents assert that polygraph tests are "widely considered to be accurate, although, not foolproof," and that "due process" should compel inclusion of the test results as evidence. The Kabani Respondents fail to acknowledge the significant weight of authority doubting the reliability and admissibility of polygraph test results in judicial proceedings. *See Carlton Wade Fleming, Jr.*, SEC Rel. No. 34-36215, 1995 SEC LEXIS 2326 at *5 n.5 (Sept. 11, 1995) (determining not to rely in reviewing NASD decision on testimony of polygraph examiner called by respondent, noting that, "[t]raditionally, courts have been reluctant to admit polygraph examinations"); *see generally* 1 Kenneth S. Broun, *McCormick on Evidence* § 206 (7th ed. 2013) ("A categorical rule of exclusion for polygraph results is a logical and defensible corollary to the general principles of relevancy."). In refusing to admit as evidence polygraph test results, courts have noted that "the technique is not generally accepted in the scientific community or is 'unreliable' due to inherent failings, a shortage of qualified operators, and the prospect that 'coaching' and practicing would become commonplace if the evidence were generally admissible." *Id.* Courts are especially reluctant to admit polygraph evidence where, as here, the parties did not stipulate to the admissibility of the test results and no notice of the administration of the test was given to the opposing party. *See generally id.* ("[A]dmission of unstipulated results is so rare as to be aberrational"); *Conti v. Comm'r*, 39 F.3d 658, 663 (6th Cir. 1994) ("[U]nilaterally obtained polygraph evidence is almost never admissible under Evidence Rule 403."). We therefore deny the Kabani Respondents' motion to adduce additional evidence, and find no basis for disturbing the hearing officer's credibility determinations.

C. Attempt to repudiate Khan's answer

Respondents argue that Khan's answer, which contains several admissions that helped support findings of liability against all respondents in the hearing officer's decision, should be disregarded. In support of their argument, respondents contend that: (1) Khan was unrepresented by counsel when he filed his answer; and (2) Khan included with the answer a cover letter that should be construed as disavowing the accuracy of Khan's responses.

As to the first contention, it is well settled that proceeding without counsel does not relieve a respondent of the consequences of the representations in his or her filings, even if they could be characterized as mistakes. *See McNeil v. United States*, 508 U.S. 106, 113 (1993) (recognizing need to construe liberally pleadings prepared by pro se prisoners but stating that, in contrast, "we have never suggested that procedural rules in ordinary civil litigation should be interpreted so as to excuse mistakes by those who proceed without counsel"); *Cornejo v. Turks*, 1997 U.S. Dist. LEXIS 1545 at *1 (N.D. Ill. Feb. 5, 1997) ("[T]he solicitude that courts extend to...pro se litigants does not give them a free pass to violate the basic rules of federal pleading." (internal citations omitted)); *Michael A. Rooms*, SEC Rel. No. 34-51467, 2005 SEC LEXIS 728 at *10 (April 1, 2005) (rejecting respondent's argument that the admissions in his answer should be given "minimal weight" because he could not afford counsel and the answer was drafted by a co-respondent's attorney), *aff'd*, 444 F.3d 1208 (10th Cir. 2006).

As to the second contention, the respondents note that Khan's cover letter to his answer stated generically that, "due to the lapse of time between now and [2008], these responses are based solely on the best possible reflection and the documentary and testimonial evidence(s) produced from the initiation of this proceeding up to date. There are chances of errors and omissions in each of these responses and as a result should not be construed as firm responses." Board Rule 5421 requires, however, that an answer shall "specifically" admit, deny, or state that the party does not have, and is unable to obtain, sufficient information to admit or deny "each" allegation in the order instituting proceedings. And if Khan filed his answer in good faith with the incomplete information then available to him but later learned information that rendered admissions he made inaccurate, then he should have timely sought to amend his answer. *See generally Missouri Housing Dev. Comm'n v. Brice,* 919 F.2d 1306, 1314 (8th Cir. 1990) ("'[A]dmissions in the pleadings...are in the nature of judicial admissions binding upon the parties, unless withdrawn or amended.'" (quoting *Scott v. Comm'r*, 117 F.2d 36, 40 (8th Cir. 1941))). In the absence of any attempt to amend his allegedly inaccurate responses, his admissions may fairly stand. *See generally Davis v. A.G. Edwards & Sons, Inc.,* 823 F.2d 105, 107-08 (5th Cir. 1987) (per curiam) (holding earlier judicial admissions binding, even though admitting party submitted an affidavit at summary judgment that conflicted with earlier statements in his complaint).

The respondents have made no attempt to identify which of Khan's responses were inaccurate, correct them by reference to new evidence, or explain why he could not have given accurate responses in his original filing. And, in any event, it is unlikely that Khan could have made a showing of good cause for failing to correct his supposedly erroneous admissions, as the hearing officer has pointed out that his wholesale attempts to distance himself from his answer are "not credible": at the hearing, when specifically asked whether the responses in his answer were truthful, Khan responded that he simply had "no independent recollection of whether the answers are correct or incorrect." *See* I.D. 57. Under these circumstances, we find no valid basis to disregard Khan's answer. *See, e.g., Columbus Bank & Trust Co. v. McKenzie Trucking & Leasing LLC*, 2009 U.S. Dist. LEXIS 98882 at *22-23 (M.D. Ga. Oct. 23, 2009) (rejecting attempt to disavow admissions in answer where "excuses" for defendant's delay in correcting the alleged inaccuracies, including that he needed additional "'investigation and discovery,'" did not "ring[ ] true").

D. Procedural arguments

The respondents also make several procedural objections to this proceeding, none of which are meritorious. We address each in turn below.

1. Opportunity to present expert witness

The Kabani Respondents argue that the hearing officer improperly denied them permission to present their expert witness of choice when they moved on the eve of trial to introduce a different expert. But their petition fails to acknowledge the considerable accommodations made by the hearing officer to grant the respondents as much latitude as fairly possible in presenting an expert witness for their defense, and we find no error in the hearing officer's decision.

As evidenced in the record, the Kabani Respondents were represented by different counsel when this proceeding was instituted. That counsel was aware by September 2012 that the Division intended to call a data forensics expert. Counsel requested and received two extensions of time from the hearing officer before exchanging expert reports with the Division on November 4, 2012. The Kabani Respondents' expert witness was identified as an individual who had assisted Kabani & Co. in setting up and maintaining their data storage and other computer systems. On

December 24, 2012, the Kabani Respondents unsuccessfully moved to strike the Division's expert's report (on grounds including its "morbid excess") but were granted an extension of time within which to submit a revised expert report responding to the Division's submission. In March 2013 the Kabani Respondents' counsel withdrew from representing them. The Kabani Respondents immediately retained new counsel who, on April 26, 2013 (six weeks before the hearing, which had already been postponed at the new counsel's request), moved for permission to present a different expert.

In denying the motion, the hearing officer noted that the Kabani Respondents, in a declaration supporting the motion, "recognize[d] that their motion is untimely, that the expert-related deadlines have previously been extended 'on several occasions' and that 'prior counsel had an opportunity to identify and present an adequate expert witness to explain the scientific invalidity and deficiencies of the [Division's expert's] Report.'" *See* Order Denying Kabani Respondents' Motion to Present Testimony at the Hearing (May 8, 2013) at 3. Thereafter, the hearing officer made repeated accommodations during the hearing to assist the Kabani Respondents in presenting the testimony of their initial expert, who had then become difficult to reach and unwilling or unable to commit to appear for the hearing. Those accommodations included granting permission to the Kabani Respondents to have their alternate expert attend the hearing during the Division's expert's testimony and serve as consultant to counsel during breaks in questioning. Ultimately, the Kabani Respondents were unable to secure the initial expert's live testimony, but his report stands in the record.

The powers of the hearing officer include "regulating the course of a proceeding and the conduct of the parties and their counsel" and, "subject to any limitations set forth elsewhere in [the Board's] Rules, considering and ruling upon all procedural and other motions." Board Rule 5200(b)(4) & (8). There is no Board rule specifically addressing the standard for deciding whether a hearing officer should accommodate a request to modify an order setting case deadlines, but, in the context of administrative proceedings, courts have recognized generally the "broad discretion [an] agency has in ordering the conduct of its proceedings." *Dearlove v. SEC*, 573 F.3d 801, 807 (D.C. Cir. 2009). We note that Rule 5411 does provide, as to the filing of any papers for which time limits are prescribed by Board rule, that, "[e]xcept as otherwise provided by law," the hearing officer, at any time prior to filing of his or her initial decision, may, "for good cause shown," extend or shorten those time limits. And we further note that courts uniformly recognize that presiding trial judges are authorized to "control and expedite pretrial discovery through a scheduling order." *Buchanan v. Gulfport Police Dep't*, 2011 U.S. Dist. LEXIS 145261, at *2 (S.D. Miss. Dec. 16, 2011). The trial judge is afforded "broad discretion to preserve the integrity and purpose of the pretrial order." *Geiserman v. MacDonald*, 893 F.2d 787, 790 (5th Cir. 1990). Under Federal Rule of Civil Procedure 16(b)(4), which does not apply to PCAOB proceedings but to which we may look for guidance, a party wanting to modify a court's scheduling order (such as one establishing time limits on the introduction of expert witnesses) must show "good cause" for doing so. F. R. Civ. P. 16(b)(4) (permitting a schedule to be "modified only for good cause and with the judge's consent"). Consistent with that guidance, the hearing officer in this case repeatedly put the parties on notice that scheduling orders would not be modified without "good cause."

The Kabani Respondents were given a considerable amount of time to choose their expert, they made their choice and proceeded with it, and they changed their minds at an unacceptably late hour simply because their new counsel disagreed with previous counsel's strategy. Courts do not accept this as a valid basis for disrupting a fair and reasonable litigation schedule. *See Crandall v. Hartford Cas. Ins. Co.*, 2012 U.S. Dist. LEXIS 173995 at *9 (D. Idaho Dec. 6, 2012) ("A party's dissatisfaction with their expert's opinions and/or an expert's lack of regular and timely communication is an unfortunate circumstance, to be sure....However, the timely progression of a lawsuit cannot turn on whether a party is fully satisfied with the particular choice of an expert. Those are decisions, including the due diligence necessary to guard against difficulties arising from such decisions, that must be made by parties within the scheduling time-frames imposed by the Court."); *see also Adams v. Sch. Bd. of Hanover County*, 2008 U.S. Dist. LEXIS 96296 at *10 (E.D. Va. Nov. 26, 2008) ("The arrival of new counsel... does not entitle parties to conduct additional discovery or otherwise set aside valid and binding orders of the court, regardless of the efficacy of any new strategy counsel seeks to follow."); *Kenny v. County of Suffolk*, 2008 U.S. Dist. LEXIS 93120 at *3 (E.D.N.Y. Nov. 17, 2008) ("Incoming counsel is bound by the actions of his or her predecessor, and to hold otherwise would allow parties to create good cause simply by switching counsel.").

The Kabani Respondents claim that the Division would have suffered no prejudice had they been allowed to belatedly present their new expert. Even if true, however, this is of no assistance to their argument. As courts have held, "the absence of prejudice to the opposing party is not equivalent to a showing of good cause" to modify a scheduling order. *E.g., Wagner v. Circle W Mastiffs*, 2011 U.S. Dist. LEXIS 5663 at *11 (S.D. Ohio Jan. 14, 2011). The respondents were given ample time to identify an expert of their choosing, submit an expert report, revise that report to address the Division's expert's conclusions, and try to secure their expert's testimony at the hearing. They were also given ample opportunity to cross-examine the Division's expert and to consult with another expert of their choosing who was observing the Division's expert's testimony during the hearing. Under these circumstances, we find no basis to conclude that the hearing officer erred in denying the Kabani Respondents' late request to introduce a new expert, and we find no unfairness created by that decision.[2/]

[2/] We note that, even if we were to consider the Kabani Respondents' argument in the context of Federal Rule of Civil Procedure 37(c)(1), which prohibits a party from using witness testimony if the party failed to disclose the witness in a timely manner, the

2. Burdensomeness and hearing officer's level of experience

The Kabani Respondents contend that "the entire process and its result (the Amended Initial Decision) are unfair" in two respects: first, that the "burdens to defend oneself are this extreme," and second, that they were "assigned a hearing officer who has an insufficient understanding of the audit process essential to a fair hearing." We find no merit in these claims of procedural unfairness.

Few respondents, if any, may welcome a regulator's investigation or institution of an enforcement proceeding. But although the Kabani Respondents claim that, over the four years they have defended their case, the Division's "litigation tactics by themselves have practically destroyed the Firm," their allegations of misconduct are not borne out by the record. For example, they protest they were "forced to defend a six day hearing, often lasting until late at night and during the weekend." They fail to acknowledge, however, that the hearing officer extended the hearing into the evenings and the weekend largely to accommodate scheduling requests from the respondents themselves, and only upon agreement by all parties. As another example, the Kabani Respondents take exception to the fact that the hearing officer took ten months to issue his initial decision; yet they do not explain why this delay compels dismissal or how this objection is consistent with their opposition to the Division's motion to expedite our review. There is no evidence that this proceeding was conducted in any manner other than in accordance with the Rules of the Board and other applicable law. The burdens that attend a fairly prosecuted enforcement proceeding are not cause for dismissal.

Moreover, there are no grounds for accusing the hearing officer of lacking the subject matter experience necessary to conduct this proceeding, but we note that, even if such a claim had any basis in fact or law, our de novo review cures the alleged defect. *See Robert M. Fuller*, SEC Rel. No. 34-48406, 2003 SECLEXIS 2041 at *22 n.30 (Aug. 25, 2003), *petition denied*, 95 F. App'x. 361 (D.C. Cir. 2004). Khan, for his part, claims that he was "deprived of the right to due process" because he was asked during his investigative testimony about the version of the Issuer A audit file that Saeed produced

Kabani Respondents have not shown that their failure to identify their new expert was "substantially justified" or "harmless." *See Hughes v. Stryker Sales Corp.*, 2010 U.S. Dist. LEXIS 47062 at *29-30 n.12 (S.D. Ala. May 13, 2010) (denying plaintiff's request to designate an expert months after discovery had closed and less than three months before trial, finding that the failure to identify an expert sooner was not harmless because, among other things, designating a new expert would "compromise the ... trial setting, and ... guarantee the need for re-open[ing] of discovery, thereby ratcheting up the effort, expense and delay for all concerned based on an expert disclosure matter that plaintiff could and should have addressed some time ago").

but not about the version that Kabani gave to the Division in 2011. When Khan appeared for questioning, however, the Division did not yet have a copy of the file he argues he should have been questioned about, and, to the extent Khan believes he had information about the file relevant to his defense, he does not identify that information or explain how he was prevented from introducing it in this proceeding. We can find no basis for any claim of procedural unfairness.

3. Claims of bias

The Kabani Respondents argue, in a May 27, 2014 motion, that the Board must recuse itself in its entirety from review of the hearing officer's decision because the Board is biased against them. The Kabani Respondents do not specify whether they seek relief in the form of dismissal of this proceeding, review by a differently constituted Board, direct review by the SEC, or other remedy. Because we reject their argument, it is unnecessary to determine the appropriate relief.

The Kabani Respondents contend in their recusal motion that, by accepting Saeed's offer of settlement in May 2013 (just before the hearing in this case commenced), the Board demonstrated that it had already prejudged the case against the remaining respondents. This complaint fails to acknowledge or distinguish authority holding that it is not improper for an administrative body to settle proceedings against one respondent while continuing to proceed against other respondents named in the same case. As the SEC explained in another case in which this complaint was raised:

> Taken at face value, the respondents' arguments suggest that it is virtually impossible for the Commission properly to entertain individual settlements in proceedings involving multiple respondents. Every case involving multiple respondents will ordinarily have some commonality of issues with respect to all respondents, and resolution of one party's case could always be argued to pre-dispose the Commission to a particular version of the facts. However, a policy prohibiting settlements during the pendency of a multi-party proceeding would be contrary to the Administrative Procedure Act ("APA"), 5 U.S.C. § 551 et seq. as well as elementary common sense. The APA prescribes that an agency give all interested parties the opportunity for the submission and consideration of offers of settlement, when time, the nature of the proceeding and the public interest permit. 5 U.S.C. § 554(c)(1). This has been our consistent practice for many years.

The Stuart-James Co., Inc., SEC Rel. No. 34-28810, 1991 SEC LEXIS 168 at *3 (Jan. 23, 1991) (internal footnote omitted). The Board is not bound by the APA, but Board rules provide for the submission of a settlement offer "at any time." *See* Rule 5205(a).

The Board's acceptance of such an offer would impermissibly affect the remainder of the proceeding against other respondents only if the Board "has in some measure adjudged the facts in advance of hearing them." *Stuart-James Co.*, 1991 SEC LEXIS 168, at *5. Our "mere exposure" to the facts of this case in approving Saeed's settlement does not constitute such prejudgment. *Id.; see also Jean-Paul Bolduc*, SEC Rel. No. 34-43884, 2001 SEC LEXIS 2765 at *10-12 (Jan. 25, 2001) (rejecting argument that Commission was biased on grounds that it had accepted an offer of settlement with respondents' former employer and had published findings identical to those made against respondents). The Kabani Respondents concede that the findings against Saeed were expressly limited to the settlement order and are not binding on anyone else. The findings were also neither admitted nor denied by Saeed, consistent with ordinary Board practice in settlement orders. And, as detailed in the amended initial decision, the findings of liability against the Kabani Respondents were grounded on record evidence, not on any finding in Saeed's settlement order. We therefore find no basis to recuse ourselves from deciding this case.

Khan makes a separate argument that this proceeding was conducted in a biased manner. He urges in his petition that the Board should "investigate the prejudice and biased attitude displayed by the [Division] and its employees in this proceeding," contending that he and Kabani, who are of "a particular ethnic group," were treated differently than Deutchman. Khan cites in support of his contention only the fact that he and Kabani were questioned during the hearing for a longer period of time than Deutchman. Our review of the entirety of the record of these proceedings reveals no evidence of inappropriate or illegal conduct by any of the staff, and, as explained in the hearing officer's decision and in this order, the findings of liability and sanctions determinations were made in accordance with applicable law and Board Rules and are well supported by the evidence. We can find no basis to credit Khan's assertion. *See Orlando Joseph Jett*, SEC Rel. No. 34-49366, 2004 SEC LEXIS 504 at *82 (Mar. 5, 2004) (noting that discrimination, if it had occurred in the proceeding, would have been "repugnant and intolerable" but finding respondent's claims thereof "vague and unsubstantiated" and concluding, after "an exhaustive de novo review of the record," that there was "no evidence that this proceeding was tainted by racial animus").

IV. Sanctions

The Kabani Respondents object to the sanctions imposed on them primarily by reiterating their challenges to the findings of liability in the amended initial decision and by pointing to Kabani's polygraph results, which they contend "conclusively refut[e] the propriety of [the] sanction[s]." We have already addressed these arguments above. Khan asserts that the sanctions imposed on him are "completely unfair" but does not provide any specific support for that contention. We conclude that the hearing officer imposed sanctions that are appropriate for the Rule 4006, AS No. 3, and resulting Rule 3100 violations, reflecting consideration of the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors suggested by the record, including the state of mind involved in the violations and respondents' respective roles in that misconduct. The inspection process—which is "pivotal to the Board's ability to enhance investor protection and the accuracy of issuer auditor reports through its oversight of registered accounting firms"—would be rendered meaningless if firms were permitted with impunity to whitewash their files in advance of an inspection. *Gately & Assocs., LLC*, SEC Rel. No. 34-62656, 2010 SEC LEXIS 2535 at *3 (Aug. 5, 2010) (sustaining revocation of registration and bar for failure to cooperate with a Board inspection even where there was no evidence of fraud or deceit). Misconduct is especially troubling and deserving of serious sanctions where, as here, respondents went to considerable lengths to conceal their actions and might have been successful in deceiving the Board if Saeed had not reported his concerns.

V. Conclusion

After a de novo review of the record, as well as a review of all of the parties' motions and petitions for review, we therefore summarily affirm the amended initial decision's findings of violation and imposition of sanctions with respect to the respondents' failure to cooperate with a Board inspection, in violation of Rule 4006, respondents' violation of AS No. 3, and their resulting violation of Rule 3100.[3/]

[3/] In addition, as discussed above and in light of our summary affirmance, we deny all motions the parties have filed with us, with the following exceptions. The Division filed a motion to expedite our review, which, for practical purposes, is consistent with our decision to proceed by summary affirmance, and we therefore grant that motion to the extent not inconsistent with this final decision and related order. In concert with its motion to expedite, the Division also filed a motion under Board Rule 5464 to supplement the record with certain publicly available information about Kabani & Co.'s activity related to audit reports for issuers from late 2012 through 2014. In opposing the motion, the Kabani Respondents do not contest the accuracy of this data that the Division gathered from issuer filings with the SEC but do take issue with the Division's interpretation of certain of the data. Leaving aside whether the Division has made the showing described by Rule 5464, we have discretion under that rule to accept the information into the record. Because the information appears to be publicly available information of which the Board could take official notice in any event, because the Kabani Respondents do not contest the accuracy of the data, and because we take into account the Kabani Respondents' arguments about the Division's interpretation of certain of the data, we see no prejudice in allowing the record to reflect the information.

In light of the sanctions that we find appropriate to impose by summary affirmance, we find it unnecessary to consider, and we set aside the initial decision as it relates to, the other violations charged in the order instituting disciplinary proceedings.

Accordingly, it is ORDERED that:

The registration of Kabani & Company, Inc., is permanently revoked;

Hamid Kabani is permanently barred from being an associated person of a registered public accounting firm, and shall pay a civil money penalty of $100,000;

Michael Deutchman is barred from being an associated person of a registered public accounting firm, provided that he may petition the Board to terminate the bar after two years, and shall pay a civil money penalty of $35,000;

Karim Khan Muhammad is barred from being an associated person of a registered public accounting firm, provided that he may petition the Board to terminate the bar after 18 months, and shall pay a civil money penalty of $20,000; and

All respondents are censured.

Each civil monetary penalty shall be paid by (a) United States postal money order, certified check, bank cashier's check, or bank money order, (b) made payable to Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies the payer as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If a respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanctions on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If a respondent files an application for review by the Commission or the Commission orders review of the sanction against that respondent, the effective date of the sanction shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7215(e).

By the Board (Board Members
Ferguson and Hanson not participating)

Phoebe W. Brown
Secretary

January 22, 2015

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Michael Freddy,

Respondent

PCAOB File No. 105-2017-001

ORDER SUMMARILY AFFIRMING INITIAL DECISION

November 2, 2017

The Board is in receipt of a several-paragraph letter, dated October 15, 2017 and transmitted by email, from Respondent Michael Freddy, personally, in response to the September 26, 2017 initial decision by default in this disciplinary proceeding. After not previously participating in the proceeding, Freddy now urges "the Board to reconsider to cancel the civil money penalty" ordered by the initial decision because it is "beyond my ability" to pay. Freddy's letter does not contest any other aspect of the initial decision. Construing and accepting, in our discretion, Freddy's letter as a petition for Board review, we hold that it raises no issue warranting further consideration by the Board and summarily affirm the initial decision pursuant to PCAOB Rule 5460.

I. Background

The initial decision (I.D.) was based on the allegations in the Order Instituting Disciplinary Proceedings (OIP) and evidentiary materials submitted by the Division of Enforcement and Investigations in support of its motion for default. The initial decision found that Freddy was an accountant formerly employed by KAP Purwantono, Sungkroro & Surja (the Firm), the Indonesia affiliate of the Ernst & Young global network, and, as such, was an associated person of a registered public accounting firm as defined in Section 2(a)(9) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(9), and PCAOB rules. The decision further found that Freddy refused to cooperate with a PCAOB investigation, conduct for which the Board is authorized to impose sanctions pursuant to Sarbanes-Oxley Act Section 105(b)(3), 15 U.S.C. 7215(b)(3), and PCAOB Rule 5300. Specifically, the decision determined that Freddy refused to comply with two Accounting Board Demands (ABDs) issued by the Division for him to appear for testimony related to possible violations of PCAOB rules and auditing standards in connection with certain audits and reviews of an issuer, as defined by Section 2(a)(7) of the Act, 15 U.S.C. 7201(7), including a 2011 audit on which Freddy served as engagement manager. In addition to the ABDs, the first of which was served on

Freddy, through his attorney at the time, in November 2014 and the second of which was served on Freddy personally in October 2015, the decision pointed out numerous other communications by the Division to Freddy, to which he did not respond, informing him that he had been directed to appear for testimony and that he might be subject to sanctions should he refuse to cooperate with the investigation, including three emails and two letters.[1/] The decision also noted that, when Division staff traveled to Indonesia in January 2015 to take testimony of various members of the engagement team for the 2011 audit and repeatedly tried to reach Freddy by telephone, Freddy did not answer or hung up. Further, the decision discussed February 2016 investigative testimony in the record from one of those audit team members who stated, among other things, that Freddy and another team member had asked her to alter work papers for the 2011 audit for the purpose of misleading PCAOB inspectors. Additionally, the decision noted documentation in the record of text messages from Freddy to that witness showing that, while the Division was trying to contact Freddy, he was well aware of the Division's various communications, was deliberately ignoring them, fully expected to be sanctioned for his noncooperation, and advised her to avoid contact with the Division.[2/]

The Board issued the OIP on February 14, 2017. After a lengthy period in which Freddy failed to participate in the proceedings, the hearing officer entered the initial decision by default pursuant to PCAOB Rule 5409(a)(2). Despite having been personally served with the OIP in June 2017, Freddy never answered the OIP nor appeared for any of the prehearing conferences held by the hearing officer. Such failures prompted the hearing officer to issue an order in July 2017 that Freddy show cause why he should not be held in default. When Freddy failed to respond to that order, the Division filed a motion for issuance of a default decision in mid-August 2017, attaching exhibits and accompanying affidavits. As with the previously described communications dating back to November 2014, Freddy again chose not to respond.

The initial decision found that Freddy's refusal to cooperate with the PCAOB investigation was "serious misconduct warranting strong sanctions." In determining appropriate sanctions, the decision noted that Freddy prevented the Division from questioning him about potential deficiencies in the audit procedures performed during the 2011 audit, as to which, as audit manager, Freddy was "well-situated to provide potentially valuable information." The decision also considered "aggravating" evidence that Freddy's noncooperation was intentional, that after commencement of the

[1/] The record reflects that the Division sent the emails to the same email address Freddy used in sending his October 15, 2017 communication about the initial decision.

[2/] The initial decision stated that shortly after issuance of the first ABD, the Firm informed the Division that Freddy had resigned "in lieu of termination." I.D. 5.

investigation Freddy had "sent a text message to the former colleague recommending that she, too, avoid talking to the Division staff when they tried to contact her," and that Freddy had "impeded the Division's efforts to investigate the scope of the document alteration scheme, including identifying those who directed those efforts as well as those who participated in them." I.D. 11. For Freddy's misconduct, the decision ordered that, "consistent with prior rulings in adjudicated noncooperation cases," Freddy be censured, be permanently barred from associating with any registered public accounting firm, and pay a $50,000 civil money penalty. I.D. 12.

II. Summary Affirmance

The Board "may summarily affirm an initial decision based upon the petition for review, without further briefing, if it finds that no issue raised in the petition for review warrants further consideration by the Board." PCAOB Rule 5460(e); *see* PCAOB Rule 5469 ("[t]he Board may, in its discretion, act summarily on the basis of [a] petition"). Under an analogous rule, the Securities and Exchange Commission (Commission or SEC) has stated that summary affirmance is particularly appropriate where, as here, "the relevant facts are undisputed and the initial decision does not embody an important question of law or policy warranting further review." *See, e.g., Eric S. Butler*, SEC Rel. No. 64204, 2011 WL 3792730, at *1 n.2 (Aug. 26, 2011); *see also, e.g., Groendyke Transport, Inc. v. Davis*, 406 F.2d 1158, 1162 (5th Cir. 1969). We have summarily affirmed initial decisions under similar circumstances. *See Kabani & Co.*, SEC Rel. No. 34-80201, 2017 WL 947229, *8 (Mar. 10, 2017), *appeal filed*, No. 17-70786 (9th Cir. Mar. 20, 2017); *Ron Freund, CPA,* PCAOB File No. 105-2009-007 (Jan 26, 2015).

Freddy's petition for review raises no issue warranting further consideration by the Board. He contests none of the evidentiary materials underlying the initial decision and none of the facts found by the decision. Nor does he challenge any of the decision's analysis or legal conclusions based on those facts or raise any procedural objection to the decision. *See* PCAOB Rule 5460(a) (petitions for Board review must "set[] forth specific findings and conclusions of the initial decision as to which exception is taken, together with the supporting reasons for each exception") & (d) (review limited to "the issues specified in the petition for review" unless, with notice, Board broadens review). Based on our *de novo* review of the record, we conclude that the hearing officer's determinations are amply supported by the record. *See* PCAOB Rules 5460(c), 5465; *Kabani*, 2017 WL 947229, *8.

Freddy's conduct stands, as found by the initial decision, as a deliberate, complete refusal to cooperate with a PCAOB investigation, aggravated by an attempt to improperly influence a potential witness and thwart the efforts to investigate Freddy's and others' involvement in the work paper alteration scheme to which Freddy's former colleague testified and other potential violations of PCAOB rules and standards in connection with the 2011 audit. Noncooperation with an investigation is fundamentally serious misconduct that "impairs the Division's ability to investigate, which in turn impairs the Board's ability to identify violations and sanction violators" and "deprives investors of an important protection that the [Sarbanes-Oxley] Act was intended to provide." *R.E. Bassie & Co.*, SEC Rel. No. AE-3354, 2012 WL 90269, *11-*12 & n.38 (Jan. 10, 2012) ("failure to cooperate in an investigation is very serious misconduct"); *see vFinance Investments, Inc.*, SEC Rel. No. 34-62448, 2010 WL 2674858, *15 & n.46 (July 2, 2010); *cf. Brogan v. United States,* 522 U.S. 398, 402 (1998) ("[S]ince it is the very *purpose* of an investigation to uncover the truth, any falsehood relating to the subject of the investigation perverts that function."); *Geoffrey Ortiz*, SEC Rel. No. 58416, 2008 WL 3891311, *9 (Aug. 22,2008) (providing false information to NASD in an investigation "'subvert[s]' NASD's ability to perform its regulatory function and protect the public interest") (quoting *Michael A. Rooms*, SEC Rel. No. 34-51467, 2005 WL 742738, *5 (Apr. 1, 2005), *aff'd*, 444 F.3d 1208 (10th Cir. 2006)). Investigations "play a crucial role in furthering the Board's goals of investor protection and the preparation of informative, accurate, and independent audit reports." *Bassie*, 2012 WL 90269, *11. Freddy has shown no recognition of the wrongful nature of his conduct, the record provides no assurance that he would respond differently if faced with similar circumstances in the future, and absent sanctions, nothing prevents him from continuing to audit public companies. Freddy's especially egregious misconduct amply demonstrates his unfitness to audit issuers within the regulatory framework established by the Sarbanes-Oxley Act and shows the urgent need for strong disciplinary action to prevent him and others from engaging in and benefitting from such harmful conduct.

Freddy's only assignment of error in the initial decision is the $50,000 civil money penalty, which he asserts, without any detail or corroboration, is "beyond [his] ability" to pay based on his "current financial condition" and "income." As the Commission has held, the Sarbanes-Oxley Act "does not recognize ability to pay as a factor to consider in determining whether to impose a civil money penalty." *Bassie*, 2012 WL 90269, *14 n.53. Our decision in that same case indicated that even if we have discretion to consider whether ability to pay is relevant to penalty considerations in any particular case, "evidence concerning Respondents' ability to pay a penalty would be irrelevant to our determination of whether to impose a penalty" because of "the egregiousness of Respondents' noncooperation[] and the need to protect investors and advance the public interest by deterring such noncooperation." *R.E. Bassie & Co.*, PCAOB File No. 105-2009-001 at 18 (Oct. 6, 2010). The SEC agreed. *Bassie*, 2012 WL 90269, *14 n.53 (citing *Thomas C. Bridge*, SEC Rel. No. 34-60736, 2009 WL 3100582, *25 (Sept. 29, 2009) ("when conduct is 'sufficiently egregious,' the Commission may impose a sanction despite a demonstrated inability to pay"), *petition denied sub nom., Robles v. SEC*, 2010 WL 5479603 (D.C. Cir. Dec. 30, 2010)). The same analysis applies here, given the severity of Freddy's misconduct, discussed above. Furthermore, we note the general principle that where a person claims that ability to pay should be considered in imposing a monetary sanction, he or she bears the burden of proving inability to pay. *See, e.g.*, *Keith D. Geary*, SEC Rel. No. 34-80322, 2017 WL 1150793, *12 (Mar. 28, 2017). The lack of support for Freddy's claim of inability to pay a civil money penalty, despite ample opportunity to raise it before, would be a separate and independent ground for rejecting his claim.

III. Conclusion

After *de novo* review of the record, we therefore summarily affirm the initial decision's findings of violations and order of sanctions.

Accordingly, it is ORDERED that:

Michael Freddy is censured;

Michael Freddy is barred from associating with any registered public accounting firm; and

Michael Freddy shall pay a civil money penalty in the amount of $50,000 by (a) United States postal money order, certified check, bank cashier's check, or bank money order, (b) made payable to the Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies Michael Freddy as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the date the Commission lifts the stay imposed by Sarbanes-Oxley Act Section 105(e), 15 U.S.C. 7215(e).

By the Board

Phoebe W. Brown
Secretary

November 2, 2017

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of George W. Stewart, Jr., CPA,

Respondent

PCAOB File No. 105-2015-016

FINAL DECISION

December 15, 2017

Appearances

Michael S. Rosenberg and David C. Ware, Washington, DC, for the Division of Enforcement and Investigations

Carla M. DewBerry, K&L Gates LLP, Seattle, WA, for Respondent

I.

Respondent George W. Stewart, Jr., seeks Board review of the hearing officer's initial decision in this disciplinary proceeding. Stewart served as the engagement partner on the audit of the financial statements of an issuer for the year ended December 31, 2012, and a simultaneous "reaudit" of that issuer's financial statements for the year ended December 31, 2011. Stewart took on that role at the request of a partner at another audit firm who had served as the engagement partner on audits of the issuer's financial statements for more than five consecutive years and had come to understand that, under applicable law, he could not do so for the 2011 and 2012 audits.

The charges against Stewart in this case are primarily that, in leading the 2011 reaudit and the 2012 audit, he failed to exercise due professional care, including professional skepticism; failed to adequately plan and supervise the audits; failed to identify and assess the risks of material misstatement in the audits; and failed to obtain sufficient appropriate audit evidence for significant items reported in the issuer's financial statements. The hearing officer's initial decision found that "[t]he only conclusion that can fairly be drawn from this record is that Stewart agreed to serve as the 'lead partner' for the 2011 Re-Audit and the 2012 Audit 'in name only,'" essentially turning the audits over to a subordinate of the former engagement partner, and in doing so failed to "fulfill any of the responsibilities required of an engagement partner under the applicable PCAOB standards." Index to the Record on Review, Record Document (R.D.) 38, Initial Decision (I.D.) 27. The decision found the record to be "replete with evidence of Stewart's failures to obtain sufficient appropriate audit evidence or perform procedures to address insufficient appropriate audit evidence concerning relevant assertions." I.D. 33. Finding that Stewart's work on the audits was "severely deficient" and that he displayed an attitude of "indifference" to obtaining sufficient audit evidence, the decision concluded that his conduct was reckless, "or, at the very least, involved repeated instances of negligent conduct." I.D. 36, 37. The decision ordered that Stewart be censured, that he be barred from associating with a registered public accounting firm, with leave to petition to associate after three years, and that he pay a $25,000 civil penalty. It also ordered that, upon any re-association, he be restricted for a further two years from serving as an engagement partner or an engagement quality reviewer on issuer audits. Stewart seeks review of all of these determinations.

After *de novo* review of the record, in light of the arguments presented to us, we find that the violations charged are proven by a preponderance of the evidence and we determine that it is appropriate to bar Stewart from association with a registered public accounting firm, with the proviso that he may petition to associate after five years; to censure Stewart; and to order Stewart to pay a $25,000 civil money penalty.

II.

On June 29, 2015, the Board issued an Order Instituting Disciplinary Proceedings (OIP) alleging violations of PCAOB rules and auditing standards by Stewart in conducting a "reaudit" of the fiscal year 2011 financial statements and an audit of the fiscal year 2012 financial statements of Hitor Group, Inc. It is undisputed in this proceeding that at all relevant times Hitor was an issuer, as defined by Section 2(a)(7) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(7), and PCAOB rules, and that Stewart was a person associated with George Stewart, CPA (the Stewart Firm), a registered public accounting firm, as defined by Section 2(a)(9) of the Sarbanes-Oxley Act, 15 U.S.C. 7201(9), and PCAOB rules. Stewart answered the OIP on July 31, 2015. Following two days of hearings in February and March 2016, the hearing officer issued an initial decision on September 22, 2016. Stewart petitioned for Board review of that decision, and, on February 9, 2017, briefing on the petition for review concluded. Neither party requested oral argument.

III.

A. Stewart was recruited to serve as engagement partner for the 2011 reaudit and 2012 audit of Hitor and understood that on those audits he was to exercise minimal supervision.

Stewart, a 67-year-old certified public accountant licensed by the Washington State Board of Accountancy since 1982, was the sole owner and partner of the Stewart Firm at all relevant times. R.D. 1, OIP, 1-2 ¶ B.3; R.D. 13, Answer (Ans.) 1, ¶ B.3; Ex. J-54 at 1; Tr. 243-44.[1/] Stewart testified that his firm typically has 15-20 issuer clients at any given time, all of whom "receive going concern opinions," that is, as he described it, audit reports that contain a paragraph "warning [investors] that this company cannot exist for another year without some sort of external intervention" such as "attracting investors" or "attracting additional debt financing." Tr. 59, 61, 246. At the hearing, Stewart declared he had been planning to retire "within two years" and "transition" his business to another CPA, though that process was "going slower than anticipated." Tr. 243-44.[2/]

Stewart became engagement partner on what the parties refer to as the "reaudit" of Hitor's 2011 financial statements and on the audit of Hitor's 2012 financial statements at the request of Thomas Harris, owner of another sole proprietorship in Seattle, Washington, then registered with the PCAOB as Thomas J. Harris, CPA (the Harris Firm). OIP 2, ¶¶ C.1, C.2; Ans. 1-2, ¶¶ C.1, C.2. That firm, with Harris as engagement partner, had audited Hitor's financial statements for every year since the company went public in 2006. Exs. J-1 at 7-8, J-2 at 9, J-3 at 15, J-4 at 16, J-5 at 9-10, J-15 at 10, J-44 at 10-11, J-53 at 11.[3/] Stewart understood during the audits at issue that as engagement partner he was responsible for the engagement and its performance. Tr. 87, 188.

[1/] All transcript (Tr.) citations in this opinion are to Stewart's hearing testimony (R.D. 27a and 28a). No other witnesses were called at the hearing.

[2/] According to information on the Washington State Board of Accountancy website, of which we take official notice, Stewart's CPA license is currently active, "[l]icensed to practice public accounting" through June 30, 2019. *See* http://apps.cpaboard.wa.gov/Default.aspx?querytype=individual (search: Stewart) (last visited on Dec. 12, 2017).

[3/] In June 2015, the Harris Firm and Harris consented, without admitting or denying the allegations, to a Board order imposing sanctions on the basis of Board findings that they violated PCAOB rules and standards in connection with the audits of Hitor and two other issuers. *Harris & Gillespie CPA's, PLLC, and Thomas J. Harris, CPA*, PCAOB Rel. No. 105-2015-011, at 7-13 (June 16, 2015). The order imposed a $15,000 civil penalty on the Harris Firm, revoked its registration with leave to reapply after five years, censured both respondents, and barred Harris from association with a registered public

During the pertinent period, in filings with the Securities and Exchange Commission (Commission or SEC), Hitor, a Nevada corporation headquartered in Kirkland, Washington, described itself as a "development stage company with limited operations, limited revenue, limited financial backing and limited assets" that owned proprietary technology to increase vehicle fuel efficiency. OIP 2, ¶ C.3; Ans. 2, ¶ C.3. In each of its annual reports since 2006 Hitor stated there was "substantial doubt about [the company's] ability to continue as a going concern." Ex. J-15 at 9; Tr. 61. Its common stock was quoted on the OTC Bulletin Board. OIP 2, ¶ C.3; Ans. 2, ¶ C.3; Ex. J-44 at 6.

Stewart testified that he "had worked with Tom Harris for a number of years," with Harris "primarily" serving as concurring reviewer for Stewart's audits. Tr. 44. In early 2013, as Harris was preparing to audit Hitor's 2012 financial statements, the PCAOB inspection process brought to Harris's attention that, in Harris's words, he had "reached or passed the required 5 year limit" for three of his 17 issuer clients, including Hitor. Ex. J-23 at 1; *see* Ex. J-25 at 2; Ex. J-26.[4/] After communicating with Hitor about the situation, the Harris Firm retained the Hitor engagement, with Harris and Stewart agreeing that Stewart would serve as engagement partner for the audit of Hitor's 2012 financial statements and simultaneous reaudit of its 2011 financial statements. *See* OIP 4 ¶ 10; Ans. 2 ¶ 10 (Stewart admits, "In early 2013, while preparing for the audit of Hitor's FY 2012 financial statements, the [Harris] Firm and Harris determined that they might not be independent of Hitor, and might not have been independent of Hitor for the FY 2011 audit, because the FY 2011 audit had been the sixth consecutive audit for which Harris had acted as lead partner. In response, Harris asked Stewart to serve as partner for the audit of Hitor's FY 2012 financial statements, and simultaneously to conduct a 're-audit' of Hitor's FY 2011 financial statements.").

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accounting firm, with leave to petition to associate after five years. *Id.* at 16-17. The order stated, "The findings herein are made pursuant to Respondents' Offers and are not binding on any other person or entity in this or any other proceeding." *Id.* at 2 n.3.

[4/] Section 10A(j) of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1(j), provides that "[i]t shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer." The Commission has incorporated this restriction into its auditor independence rules, which provide that (subject to an exception that did not apply to the Harris Firm), an audit firm is not independent of an audit client when an audit partner performs the services of lead partner for more than five consecutive years. Rule 2-01(c)(6)(i)(A)(1) of Commission Regulation S-X, 17 C.F.R. 210.2-01(c)(6)(i)(A)(1).

Stewart testified that he could not recall the specific date on which he made that agreement with Harris. Tr. 44-45. In a letter dated March 26, 2013, copied to Stewart, however, Harris represented to Hitor's Board of Directors that, "As a result of the partner rotation requirement, Thomas J. Harris, CPA is no longer independent. In his place, George Stewart, CPA will be acting as the partner in charge and accordingly has no independence issues involving your Company." Ex. J-28 at 5.

At the hearing, Stewart stated that he and Harris "had a couple of conversations" about Stewart's assumption of the role of engagement partner. Tr. 44. From these conversations, Stewart understood that Hitor would remain a client of the Harris Firm. Tr. 49-50. Stewart testified that he "did in fact do some concurring reviews for Hitor" in the past, so that he "was familiar with how [Harris] prepared work papers and…so [he] didn't think it would be a stretch to be an engagement partner." Tr. 239. The engagement team for both audits would consist solely of Stewart, as engagement partner, and a staff employee of the Harris Firm (Staff Employee), as audit manager. Tr. 20, 29, 39. Stewart understood that Harris had arranged for another licensed CPA to perform the engagement quality reviews on the audits. Tr. 242; *see* Ex. J-23; Ex. J-32.

Stewart also testified that Harris was planning to "develop" Staff Employee into a "second partner" as a "long-term solution" to the recurring problem of complying with the five-year partner rotation rule with respect to Hitor and the Harris Firm's other issuer clients. Tr. 49-50. Stewart had never previously worked with or supervised Staff Employee on an audit engagement and knew nothing about Staff Employee's qualifications as an auditor other than that Staff Employee was licensed as a CPA and worked at the Harris Firm. Tr. 21, 181. Nonetheless, Stewart testified that from his conversations with Harris he understood that for each of the two audits, "the idea was I would have a minimal amount of supervision [over Staff Employee] because [Harris] wanted [Staff Employee] to take over executing the audit." Tr. 73, 180-81, 217-18. Stewart and Harris "planned all along" that Staff Employee would "do as much of the audit as possible" and "work with the audit programs and it was [Staff Employee's] responsibility to run with it," with "minimal supervision" from Stewart. Tr. 48, 217-18. As Stewart explained several times at the hearing, the "idea" or "plan" for each audit was "to have [Staff Employee] do as much as possible in his audit without direct supervision from me," to give Staff Employee, in other words, "as much latitude as possible to see whether he can do the audit without a great deal of supervision," while Stewart played only a "very minimal" role, and Stewart testified that "we did in fact execute that plan" during the 2011 reaudit and the 2012 audit. Tr. 39-40, 49, 180-81, 72-73, 217-18.

Additionally, Stewart testified that as to both the 2012 audit and the 2011 reaudit, he understood that although "there's going to be communication" to some extent between Harris and Hitor, Harris "could not participate in the audit because…he was over the five year limit to act as an engagement partner for the audit." Tr. 29, 32-34 ("He can't work on the audit…he couldn't perform any of the work paper documentation and he couldn't sign off on any of the programs…he didn't sign off on anything approving anything and he certainly didn't do any of the work papers."). As to communication, on April 3, 2013, Harris sent an email to Hitor management (copying Stewart) requesting online access to the company's bank accounts, asking for its "stance" on whether it intended to "write off the inventory," and asking for a meeting between management and Staff Employee so that Staff Employee could collect documents necessary to the audit work. Ex. J-32 at 1. Harris also appears to have approved at least three documents in the work papers: an incomplete "Engagement Completion Document" in the 2011 reaudit work papers that bears Harris's signature as "Engagement Partner" (Ex. J-10 at 14) and the first page of an "Audit Program for Cash," included in both sets of work papers, that bears Harris's initials. *See* Ex. J-10 at 103, Ex. J-17 at 68. Consistent with Stewart's minimalist, hands-off approach to the audits, and despite his responsibility as engagement partner for the assignment of tasks to audit assistants (*see* AU § 230.06), he did not ask Harris or Staff Employee whether Harris was taking any other actions related to the audits (Tr. 34), there is no evidence in the record that Stewart otherwise took any steps to find out, and he does not claim to have questioned Harris about the three documents, which seem on their face to conflict with Stewart's stated understanding of Harris's limited role in light of the auditor rotation requirement.

B. By design, Stewart played no role in the planning or execution of the 2011 reaudit or the 2012 audit.

Stewart testified that Staff Employee performed all planning and risk assessment procedures for both the 2011 reaudit and the 2012 audit. Tr. 40, 49, 75, 90, 179-80, 184, 188-90. Staff Employee (and, as noted above, sometimes Harris) communicated directly with Hitor management to obtain documents and information for the audit, and Staff Employee performed all of the audit procedures and prepared the work papers for both of the audits himself. Ex. J-10 at 24-48; Ex. J-17 at 29-53; Ex. J-28; Tr. 38-41. By Stewart's own account at the hearing, for both audits his supervision of Staff Employee consisted solely of reviewing emails on which Staff Employee copied him and reviewing the work papers after Staff Employee prepared them. Tr. 71. Stewart also testified that he did not himself "send any e-mails to [Staff Employee] regarding this audit" and could not recall any phone conversations or meetings with him during the audits. Tr. 48-50.

More specifically, Stewart did not discuss with Staff Employee his responsibilities for performing the audits, did not participate in the planning of the audits, did not participate in the development of an audit plan or strategy, and did not direct Staff Employee to bring any significant accounting or auditing issues to Stewart's attention. Tr. 74-75, 182-84. Stewart admitted that "there was no formal planning session where we sat down and we went over and formalized any audit record or discuss[ed] the audit plan" because "Mr. Harris'[s] idea" "was to have [Staff Employee] do as much as possible in his audit without direct supervision from me." Tr. 49. Stewart testified that he understood that Staff Employee would be using "generic" audit programs, a "common procedure" among "smaller firms," and that he expected Staff Employee to tailor them as necessary to the Hitor audits. Tr. 38, 40. Stewart stated that "the planning procedures are to examine the generic programs that are necessary to conduct an audit and then turn them over to, in this case, [Staff Employee]." Tr. 39. But Stewart conceded that the predicate task of identifying the appropriate audit programs and procedures to use also fell to Staff Employee: "Well, yeah, that's part of the process. You want to see his ability to pick the appropriate programs and to decide which appropriate work papers to gather in order to complete the audit. That's part of the training process and can he handle it. And you turn over a set of generic programs and can he complete the audit. That's what you're looking for." Tr. 40. Stewart operated on the assumption that Staff Employee "was expect[ed] to know" which procedures the audits called for. Tr. 72.

Without input or direction from Stewart (Tr. 75, 184), Staff Employee assessed the risk of material misstatement for all accounts relevant to this proceeding in both audits as "low" (Ex. J-10 at 246, 248; Ex. J-17 at 222-23).[5/] In support of these risk assessments, Staff Employee obtained: (1) a two-page "Fraud Awareness Questionnaire," which was signed by Hitor's chief executive officer (CEO) on March 27, 2013 and consisted of a check mark or "x" by the CEO in "yes," "no," or "N/A" columns next to 26 pre-printed questions; and (2) a one-page "Analysis of Internal Controls for the year ended December 31, 2012," a form that was completed and on April 2, 2013 provided to Staff Employee by the CEO and in which the CEO wrote "we have no employees" near the top and his own name under "Employees" next to ten pre-printed items or factors under "Cash Receipts" (*e.g.*, "Receives checks"), eight under "Disbursements" (*e.g.*, "Prepares checks"), and eight under "Miscellaneous" (*e.g.*, "Has password to general ledger"). Staff Employee included identical copies of the Questionnaire and the Analysis of Internal Controls in the work papers for both the 2011 reaudit and the 2012 audit. Ex. J-10 at 243-45; Ex. J-17 at 219-21. Nothing in the work papers suggests Staff Employee performed any audit procedures on these documents. *See* Ex. J-10 at 243-45; Ex. J-17 at 219-21; Tr. 91-92. Stewart testified he was aware that Staff Employee did nothing with the documents except receive them and place them in the work paper files. Tr. 97.[6/]

[5/] The two areas assessed as presenting a "moderate" risk were Income & Expense and Commitments. Ex. J-10 at 246, 248; Ex. J-17 at 222-23.

[6/] On the Analysis of Internal Controls form, Hitor's CEO stated that the company had "no employees." Ex. J-10 at 245; Ex. J-17 at 221. This conflicted with the statement in Hitor's draft Form 10-K, a copy of which was included in the 2011 reaudit work papers, that Hitor employed a sales manager. Ex. J-10 at 329. The work papers Staff Employee prepared and Stewart reviewed did not document that Staff Employee noticed or followed up on this discrepancy, nor is there any indication in the record that Stewart

Stewart reasoned that "you wouldn't normally follow up" on this information because "the purpose of those two documents is to assess how much reliance you're going to place on the controls that the company has in place," and he understood that "with [a] development stage company with no employees, as a practical matter, you can't put any reliance on the controls." Tr. 92-93. Yet he did not discuss with Staff Employee how this or any other aspect of Hitor's business environment or controls could affect Staff Employee's work. Tr. 74-75, 183. For both audits, Staff Employee worked on his own to set planning materiality at $12,000 with a "tolerable misstatement" level of $9,000. Ex. J-10 at 251; Ex. J-17 at 227; Tr. 180. As discussed below, all assertions in the financial statements for which insufficient supporting evidence was obtained involved dollar amounts that significantly exceeded the thresholds Staff Employee set.

C. Stewart failed to identify or attempt to understand or resolve several deficiencies and discrepancies in both sets of audit work papers.

Stewart began his review of the work papers for both the 2011 reaudit and the 2012 audit the day before Hitor intended to file with the SEC a Form 10-K that included in one document a reissuance of the 2011 financial statements and a first-time issuance of the 2012 financial statements. Tr. 51-52; *see* Ex. J-44 at 12. During April 15 and 16, 2013, Stewart spent a total of four hours, combined, reviewing the work papers for both of the audits. Ex. J-49; Tr. 51-54. He did not contact Staff Employee with any questions before signing off on Staff Employee's work. Tr. 73. The work papers for both audits, however, contain several significant deficiencies and discrepancies that Stewart did not identify or attempt to resolve, as detailed below.

1. Deficiencies and discrepancies in the 2011 reaudit work papers

In his review of the work papers for the 2011 reaudit, Stewart failed to identify or try to understand or resolve deficiencies and discrepancies in the work papers related to assertions in the financial statements as to both assets (including cash and inventory) and liabilities (including convertible notes payable, a deposit, and notes payable).

noticed or followed up on it. *See, e.g.,* Tr. 94-97. The draft Form 10-K in the work papers is likewise internally inconsistent on this point. On the same page of the 10-K, the company represents both that it "hope[s] to hire [a] sales representative in the next 12 months who will work with our sales manager," and also that, "[o]ther than Hitor's Directors and Executive Officer, who are currently donating their time to the development of the company, there are no employees of Hitor Group." Ex. J-10 at 329. The inconsistency carried through to the final version of the Form 10-K. Ex. J-44 at 4, 5.

a. Assets: cash

On its balance sheet Hitor reported a cash balance of $109,402 as of December 31, 2011, which represented more than 59% of Hitor's total reported current assets of $185,370. Ex. J-44 at 12. Stewart believed that Hitor's cash was a material item on its balance sheet. Tr. 69. The risk planning work paper that Staff Employee created for the 2011 reaudit indicated that, in order to "minimize risk," Staff Employee would "[a]nalyze client's bank reconciliations and confirm directly with the bank." Ex. J-10 at 246. Staff Employee, however, prepared but did not send a confirmation request to Hitor's bank. Ex. J-10 at 364; Tr. 146-47. Instead, notations in the work papers indicate that Staff Employee compared bank statements that Hitor provided to Staff Employee with Hitor's accounting ledger and with select lines in Hitor's trial balance for the two of Hitor's cash accounts with the largest balances. Ex. J-10 at 107, 365-96; Tr. 147-51.

As noted above, on April 3, 2015, almost two weeks before Stewart reviewed Staff Employee's work, Stewart had been copied on an email that Harris sent to Hitor management stating, "I don't seem to be able to get online to view the bank accts" and asking management for help in gaining online access to them. Ex. J-32 at 1. There is no evidence of a response in the record, and Stewart testified that he did not recall any later correspondence on the issue. Tr. 155. There is no indication in the record that Stewart took any steps to learn whether or how the problem was resolved, that is, to ascertain whether Staff Employee was able to obtain the bank statements directly from the bank or otherwise determine that those statements were reliable as audit evidence. Staff Employee did not include in the work papers copies of the bank statements he had inspected, and Stewart admittedly took no steps to inspect the bank statements himself. Tr. 151. Stewart did not discuss with Staff Employee whether there were any indications that those statements were illegitimate or had been altered. Tr. 151.

Staff Employee's documentation of his work to compare the bank statements to Hitor's accounting ledger indicates his work was incomplete. Specifically, he noted that a bank statement for Hitor's largest bank account agreed with Hitor's cash subledger for that account as of Tuesday, December 27, 2011 (Ex. J-10 at 395-96; Tr. 153-54) and that the bank statement for Hitor's second-largest account agreed with the cash subledger as of Thursday, December 29, 2011 (Ex. J-10 at 391-92; Tr. 151-53). But Stewart conceded there is no evidence in the work papers that Staff Employee did any audit work to address the intervening period between those confirmation dates and the December 31, 2011 balance sheet date on which the aggregated balance of these accounts was reported. Tr. 153. Stewart did not himself perform any procedures on Hitor's reported cash balance as of December 31, 2011. Tr. 150-51. He signed off on Staff Employee's work without comment or question. Ex. J-10 at 1; Tr. 71-76.

b. Assets: inventory

On its balance sheet Hitor reported inventory of $75,968 as of December 31, 2011, which represented over 40% of its total reported assets. Ex. J-44 at 12. Stewart believed that inventory was a material item on Hitor's balance sheet for the 2011 reaudit. Tr. 70. The risk planning work paper in the record indicates that, to "minimize risk," Staff Employee would "obtain confirmation" of the inventory. Ex. J-10 at 246.

The 2011 work papers contain a spreadsheet prepared by Hitor that, among other things, indicated that there was no change in the amount of Hitor's reported inventory from year-end 2010 to year-end 2011. Ex. J-10 at 256-57; *see* Tr. 133. On March 26, 2013, Staff Employee sent an email to Hitor, with a copy to Stewart, requesting certain information including support for Hitor's valuation of inventory, stating, "Inventory hasn't changed for several years. Do you have any documentation to provide us with that supports the value of $75,968?" Ex. J-34 at 1. The record contains no response from Hitor, and, as Stewart conceded, the 2011 reaudit work papers do not document any procedures performed by Staff Employee or Stewart to test the valuation of the inventory Hitor was reporting as of December 31, 2011. Tr. 133-35.

Stewart knew when reviewing the 2011 reaudit work papers that Hitor would be writing off the entire value of the inventory to $0 on its 2012 financial statements. Ex. J-44 at 12; *see* Tr. 203. Stewart conceded that he did not consider whether Hitor's write-off of its inventory in 2012 suggested that the 2011 amount for inventory on Hitor's balance sheet might have been materially misstated, asserting that "primary responsibility for the financial statements rests with the client." Tr. 139-40.

Stewart also testified that, because of Hitor's planned write-off of its inventory, he did not consider it necessary to perform any procedures to confirm the existence of the inventory for the 2011 reaudit. The original 2011 audit performed in early 2012 seems to have involved a physical count of the inventory. Ex. J-11 at 55. But the 2011 reaudit work papers contain no evidence of whether Staff Employee or Stewart considered that count as evidence for their own audit or considered whether it would be appropriate to rely on the original 2011 audit work in lieu of performing their own procedures. To the contrary, Stewart testified during the hearing that he "didn't consider" whether he needed to perform his own count during the reaudit. Tr. 206. He conceded that such a count would have been "possible," but, he testified, "since we knew it was going to be written off [in 2012], why would we go back and do that?" Tr. 207. According to Stewart, "These are pretty small audits and…as a practical matter you're not going to spend a lot of time counting things that you are not going to put on the balance sheet. You don't have a lot of time to waste on these things." Tr. 206. Stewart signed off on Staff Employee's work without comment or question. Ex. J-10 at 1; Tr. 73.

c. Liabilities: convertible notes payable, deposit, and notes payable

As of December 31, 2011, Hitor reported on its balance sheet current liabilities of $805,983, including, among other things, convertible notes payable of $400,000, a deposit of $150,000, and notes payable of $81,270. Ex. J-44 at 12. Together these items represented about 78% of its total reported liabilities (and individually, 49%, 19%, and 10%, respectively). *Id.* Stewart believed that each of these amounts was material to Hitor's 2011 balance sheet. Tr. 70-71. The risk planning work paper in the record indicates that, to "minimize risk," Staff Employee would "review contracts and detailed schedules" for convertible notes and "trace to details" the deposit. Ex. J-10 at 246.

On April 13, 2013, Staff Employee had emailed Hitor's accountant, with a copy to Stewart, pointing out that, as to the $400,000 in convertible notes payable and $150,000 deposit, "[t]hese are old and I have no idea what for." Ex. J-36 at 2. Stewart never learned whether Staff Employee received an explanation of these liabilities. Tr. 107-08.

The audit program in the work papers (Ex. J-10 at 173-77, "Audit Program for Notes Payable and Long-term Debt") indicates that Staff Employee was to use "an analysis of the notes payable, long-term debt, capitalized lease obligations, and other financing transactions or arrangements such as lines of credit," and "[t]est the clerical accuracy of the analysis," "[t]race the opening balances to the adjusted prior year working trial balance and the ending balances to the current-year working trial balance," and "[r]eview any reconciliation to the general ledger and investigate any unusual reconciling items." Ex. J-10 at 174. Stewart testified that "you're supposed to execute…the steps articulated in the program and then you have references to where you actually did that work," noting that the program references a schedule designated "A55." Tr. 103 (citing Ex. J-10 at 174); *see* Ex. J-55 at 1 (index of Hitor audit work papers). That schedule, a short, client-prepared spreadsheet listing the company's assets and liabilities with some notations made by Staff Employee and bearing his initials (Ex. J-10 at 256-63), does not demonstrate that any procedures were performed to test any of these reported liability items—the $400,000 convertible notes payable, the $150,000 deposit, or the $81,270 notes payable. *See* Ex. J-10 at 258-59, line 49 (listing $400,000 in notes payable with no comments or notations), line 50 (listing deposit of $150,000 with no comments or notations), lines 51-54 (listing total of $105,770.28 in three separate loans payable with no comments or notations). Stewart signed off on Staff Employee's work without comment or question. Ex. J-10 at 1; Tr. 71-76.

d. Management representation letter and response to management inquiry of the company's lawyer

Obtaining written representations from company management, as well as requesting that management send a letter of inquiry to the company's lawyers with whom management consulted concerning litigation, claims, and assessments, for the year under audit, are presumptively mandatory audit procedures and were listed in the 2011 reaudit work papers as the first two audit tasks to perform.[7/] Both Staff Employee and Stewart indicated in those work papers that they reviewed Hitor's management representation letter and the response to management's inquiry of Hitor's outside lawyer (referred to in the work papers as a "legal representation" letter). Ex. J-10 at 1, 17, 18.

The management representation letter was intended to serve as the company's confirmation to its auditors that, among other things, the financial statements "are fairly presented in conformity with U.S. generally accepted accounting principles," that the company has made available to its auditors "all [f]inancial records and related data," and that management has no knowledge of "any fraud or suspected fraud affecting the [c]ompany." *Id.* at 9. The "legal representation letter" was meant to inform the auditors of any "pending or threatened litigation, claims, and assessments." *Id.* at 11.

Yet the management representation letter in the 2011 reaudit work papers states that it was provided "in connection with [the] audit of the balance sheet of [Hitor] as of December 31, 2012," not the reaudit of the financial statements for the period ending December 31, 2011. *Id.* at 9-10 (schedule A01). Those work papers include a copy of

[7/] *E.g.*, AU § 333.01, *Management Representations* ("This section establishes a requirement that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained."), .05 ("Written representations from management should be obtained for all financial statements and periods covered by the auditor's report."); AU §§ 337.06, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* ("the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments"), .08 ("A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments."), but a lawyer's "refusal to furnish the information requested" in an inquiry letter "would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion."), .13 (a lawyer's "refusal to furnish the information requested" in an inquiry letter "would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion"); PCAOB Rule 3101(a)(2) (explaining that a PCAOB auditing standard that uses the word "should" imposes a responsibility that is "presumptively mandatory," meaning that failure to discharge it "is a violation of the relevant standard and Rule 3100" unless the auditor "demonstrates that, in the circumstances, compliance with" that responsibility "was not necessary to achieve the objectives of the standard" and that "alternative actions he or she followed in the circumstances were sufficient to achieve [its] objectives"); Ex. J-10 at 1; Ex. J-17 at 1.

an unanswered request from Hitor to its outside lawyer for a letter concerning litigation, claims, and assessments in the course of "an audit of our financial statements for the year ended December 31, 2012" (*id.* at 7-8 (schedule A03)), but no request for the year ended December 31, 2011. A response letter from the outside lawyer appears in the 2012 work papers, but, consistent with Hitor's request, the letter states it was provided by counsel "in connection with [the] examination of [Hitor's] accounts as of December 31, 2012," not as of the end of 2011. Ex. J-17 at 15-16 (schedule A03).

Stewart conceded that neither a management representation letter for 2011 nor a lawyer response letter for 2011 appears in the 2011 reaudit work papers. Tr. 162. When asked if Hitor requested a lawyer response letter for the 2011 reaudit, Stewart testified, "I don't know, but certainly in that case if it was, it would be in the previous work papers and there would be little point of asking on December 31st of 2012." Tr. 156. But no lawyer response letter exists in Harris's original 2011 audit work papers, and Stewart could not recall ever seeing such a letter. Ex. J-6; Tr. 157-58. Even so, Stewart signed off on Staff Employee's work. Ex. J-10 at 1; Ex. J-47 at 1.

2. Deficiencies and discrepancies in the 2012 audit work papers

In his review of the work papers for the 2012 audit, Stewart failed to identify or attempt to understand or resolve the following deficiencies and discrepancies in the work papers related to assertions in the financial statements as to both assets (including inventory, prepaid expenses, and transactions involving a Hitor Poland) and liabilities (including convertible notes payable and notes payable).

a. Assets: inventory

As noted above, Hitor wrote off its inventory during 2012, and reported $0 as the value of inventory on its balance sheet as of December 31, 2012, compared to $75,968 as of December 31, 2011. Ex. J-44 at 12; Tr. 203. This reduced Hitor's reported assets by over 30% for 2012. Ex. J-44 at 12. Stewart considered Hitor's write-off of its inventory to be a material event for Hitor's 2012 financial statements. Tr. 178. As in the 2011 reaudit, the risk planning work paper for the 2012 audit indicates that, to "minimize risk," Staff Employee would "obtain confirmation" of the inventory. Ex. J-17 at 222.

Stewart understood that Hitor had no sales in 2011 or 2012. Tr. 203. In the April 3, 2013 email from Harris to Hitor management discussed above (on which Stewart was copied), Harris was still asking for Hitor's "stance" on whether it intended to write off the inventory. Ex. J-32 at 1. No response appears in the record. As Stewart understood it, "The write[-]off was suggested by [the] CPA who was preparing the financial statements and the question was raised whether or not that should be written off and that was a decision that was made." Tr. 203. No audit procedures were performed to determine whether that decision was appropriately applied to the 2012 financial statements or should have been applied to the 2011 financials. Tr. 203-04. In fact, the work papers for the 2012 audit relating to inventory show, without comment or notation, that the inventory amount for 2012 was $75,958, not $0. *See* Ex. J-17 at 232-33, line 17). Further, neither Staff Employee nor Stewart tried to confirm the existence of the inventory being written off in 2012 (nor had they done so for the 2011 reaudit, as discussed above) because Stewart believed a count of inventory intended to be written off would have been "kind of a moot point." Tr. 206-07. Stewart signed off on Staff Employee's work without comment or question. Ex. J-17 at 1; Tr. 71-76.

b. Assets: prepaid expenses

Hitor reported a current asset of $57,617 in prepaid expenses on its balance sheet as of December 31, 2012, which did not appear on the balance sheet as of December 31, 2011. Ex. J-44 at 12; Tr. 203. This item comprised 47% of Hitor's total reported current assets for 2012 (and 40% of its total assets for 2012). Ex. J-44 at 12. Stewart considered the $57,617 in prepaid expenses to be material to Hitor's balance sheet at the time of the 2012 audit. Tr. 178.

The risk planning work paper in the record states that, to "minimize risk," Staff Employee would "review [the] contract" related to $144,043 in total "prepaid consulting expenses." Ex. J-17 at 222. He wrote in the work papers that the "contract" can be found in the "perm" (permanent client file) as schedule "F275." Ex. J-17 at 94; *see* J-17 at 233, line 18 (on client-prepared spreadsheet next to $144,042.72 prepaid expenses line item, Staff Employee noted, "They entered into a marketing agreement. F275"). A contract, dated March 2, 2012, between Hitor and a consulting firm for marketing work is included in the record, but it is unsigned and bears no indication of how the agreement for services supports the amount Hitor reported for prepaid expenses on its balance sheet. Ex. J-57 (client permanent file) at 516-17. There is no documentation in the work papers of any additional audit procedures performed to test the existence or valuation of prepaid expenses in Hitor's 2012 financial statements. Stewart signed off on Staff Employee's work without comment or question. Ex. J-17 at 1; Tr. 71-76.

c. Assets: investment in Hitor Poland

Hitor reported $23,100 as an "Investment in Hitor Poland LLC" under "other assets" on its balance sheet as of December 31, 2012. Ex. J-44 at 12. This amount represented all assets in the "other" category and 16% of Hitor's total reported assets. *Id.* In the 2012 audit, Stewart believed that the investment of $23,100 in Hitor Poland LLC was material to Hitor's balance sheet. Tr. 178-79. The risk planning work paper in the record indicates that, to "minimize risk" related to the $23,100 reported as "Other Current Assets," Staff Employee would "[t]race to details and invoice." Ex. J-17 at 222.

The work papers for the 2012 audit indicate that Hitor had issued checks from one of the company's bank accounts for $3,000 on May 14, 2012, to Hitor Poland LLC, a "new company," and for $20,100 on September 13, 2012, to a company called "Vbine" to "buy wind turbine for Poland." Ex. J-17 at 331 (schedule F240); *see also* Ex. J-17 at 309 (schedule F114), line 567; Ex. J-17 at 323 (schedule F114), line 897. Staff Employee documented that he "traced" the total $23,100 amount to an invoice. Ex. J-17 at 233 (schedule A55). That invoice, prepared by Hitor and initialed by Staff Employee, indicates that a company called Vbine Energy, in Canada, sold a wind turbine for $20,100 to Hitor on August 23, 2012, and that the item was to be shipped to Hitor's office in Kirkland, Washington. Ex. J-17 at 332 (schedule F240.1); Ex. J-55 at 2 (work paper index). The invoice did not refer to Poland or to Hitor Poland, nor does it mention or otherwise appear to support the earlier payment of $3,000. Stewart testified that he did not know what Hitor Poland was but that Hitor itself was a "development stage company and they try any number of things" and "s[o] it's not unusual they would try a new investment opportunity." Tr. 208. The work papers for the 2012 audit do not document that Staff Employee performed any audit procedures regarding the purchase of the wind turbine other than obtaining a copy of the Hitor-prepared invoice and including it in the work papers. Tr. 210-11. Neither Staff Employee nor Stewart documented any inquiry made of Hitor as to how a purchase of a wind turbine bought from a Canadian company and shipped to Washington State might relate to an investment in a company in Poland. Despite the discrepancies, Stewart signed off on Staff Employee's work without comment or question. Ex. J-17 at 1; Tr. 71-76.

d. Liabilities: convertible notes payable and notes payable

Hitor reported convertible notes payable of $487,019 and notes payable of $168,662 as current liabilities on its balance sheet as of December 31, 2012. Ex. J-44 at 12. These amounts represented, respectively, 48% and 17% of Hitor's total reported liabilities (combined, 65%). At the time of the 2012 audit, Stewart believed that both the convertible notes payable of $487,019 and the notes payable of $168,662 were material to Hitor's balance sheet. Tr. 179. The risk planning work paper in the record indicates that, to "minimize risk" related to the reporting of convertible notes payable, Staff Employee would "[r]eview contracts and detailed schedules." Ex. J-17 at 222.

The work papers for the 2012 audit contain two different amounts for Hitor's liability for convertible notes payable: one for $762,647 (Ex. J-17 at 222-23) and another for $400,000 (Ex. J-17 at 235). Both of these amounts are materially different from the $487,019 reported in Hitor's financial statements. Tr. 222.

At the hearing, Stewart was unable to explain how the documentation in the work papers supported the amount of the convertible notes payable reported in the financial statements. Instead, he testified that the work papers contained cross-references to schedules that Stewart had reviewed and "where you would expect to find the support [for the $487,000]," but "[i]t's never going to be a one-for-one." Tr. 225-27. The schedules Stewart pointed to at the hearing contain no documentation of any audit procedures performed to test the reported figure of $487,000 for convertible notes payable. *See* Ex. J-17 at 252-275 (schedule B10, consisting of the firm's audit opinion and copies of Hitor's financial statements); Ex. J-17 at 276-77 (schedule C20, showing figure of $400,000 for convertible notes payable and referring to schedule F302 (Ex. J-17 at 333-34, also showing trial balance of $400,000)); Ex. J-17 at 282-329 (schedule F114, spreadsheet documenting testing of cash balances unrelated to the reported convertible notes payable); *see also* Ex. J-17 at 234-36 (schedule A55, showing $400,000 figure, unannotated). A note to the financial statements regarding the reported figure for convertible notes payable discusses various note purchase agreements and other transactions entered into by the company. Ex. J-44 at 19. Although these agreements appear to be included as part of the auditor's permanent file for the company, *see* Ex. J-57, there is no evidence in the work papers that Staff Employee inspected those agreements as part of any effort to determine whether the agreements supported the amount reported in the financial statements, and Stewart testified that he did not review the agreements himself. Tr. 230.

Similarly, the 2012 audit work papers do not document any audit procedures performed related to the notes payable of $168,662 reported on Hitor's balance sheet as of December 31, 2012. At the hearing, Stewart could not explain how the figure was tested. Tr. 227-29; *see* Ex. J-17 at 234-35. Related to the that figure, Hitor disclosed in footnote 8 to its 2012 financial statements that one of its notes payable was "secured by inventory." Ex. J-44 at 19. Staff Employee did not document any procedures performed to ascertain what impact Hitor's write-off of its inventory during 2012 might have on the relevant assertions of notes payable, one of which notes was secured by inventory that was now valueless, and Stewart testified that he made no such assessment himself. Tr. 231-32. Stewart signed off on Staff Employee's work on these reported liabilities without comment or question. Ex. J-17 at 1; Tr. 71-76.

D. Stewart signed off on the work papers for both audits and Hitor filed its Form 10-K containing both sets of financial statements and the audit report, in the name of the Harris Firm, on those financial statements.

On April 15, 2013, after performing the field work and preparing the work papers for the 2011 reaudit and the 2012 audit, Staff Employee notified Stewart that the work papers were available to review remotely using Dropbox, an internet-based file storage and sharing service. Ex. J-47 at 4-5; Tr. 51-53. Stewart testified he began his review of the work papers that day, spending a total of four hours on the review. Tr. 51-54; *see* Ex. J-49 at 1. As noted above, he did not contact Staff Employee with any questions about the audit planning or procedures performed. Tr. 73. Stewart emailed Harris on

April 15, copying Staff Employee, to note that a "signed management representation letter" needed to be obtained "before we can grant final consent" to release the audit opinion. Ex. J-48 at 3. Stewart did not specify whether the letter was missing from the 2011 work paper file, the 2012 work paper file, or both. Staff Employee responded early the next morning that "[w]e have it in the file," and Harris clarified a few hours later that it could be found "in the Dropbox." Ex. J-48 at 1-2. Stewart then emailed Harris and Staff Employee to say that he had "[f]ound the management representation letter. Signed off on Work papers. Hitor can file." Ex. J-47 at 1. As noted above, identical copies of the same management representation letter appear in both the 2011 reaudit and 2012 audit work paper files. Stewart stipulated that the record contains "complete copies of Respondent's audit work papers for the December 31, 2011 reaudit and December 31, 2012 audit of Hitor Group, Inc." at Exhibits J-10 and J-17, respectively. R.D. 30.

To Stewart, his April 16, 2013 "sign-off" meant that he had "completed [his] work" on the audits and that it was appropriate for Hitor to proceed with filing its 2012 Form 10-K. Tr. 54-55.[8/] Stewart understood that Hitor's 2012 10-K would include an audit report in the name of the Harris Firm on Hitor's 2012 and 2011 financial statements and that the opinion would be unqualified but the audit report would include a "going concern" explanatory paragraph. Tr. 59-60, 63; *see* Br. 14. Stewart testified that he understood that even when an audit report is expected to include a going concern paragraph, "[y]ou have to do an audit in accordance [with] PCAOB standards." Tr. 68.

On April 16, 2013, Hitor filed a Form 10-K with the SEC that contained Hitor's financial statements for the years ended December 31, 2011 and December 31, 2012. Ex. J-44 at 12. The Form 10-K contained an "Independent Auditor' [sic] Report on Financial Statements" in the name of the Harris Firm and dated April 15, 2013. The audit report stated, "We have audited the accompanying financial statements of Hitor Group, Inc., which comprise the balance sheet as of February 28, 2013, and the related statements of income, stockholders' equity and cash flows for the year then ended, and the related notes to the financial statements." *Id.* at 10-11. The audit report further stated that the audit had been conducted "in accordance with auditing standards generally accepted in the United States of America." *Id.* at 10. The numbers reported on the re-issued 2011 financial statements were identical to those reported by Hitor in the original 2011 10-K filed the prior year. *Compare* Ex. J-15 at 11 *with* Ex. J-44 at 12.

[8/] At the time of Stewart's "sign-off" email to Harris, Stewart knew that the engagement quality reviews of the 2011 reaudit and the 2012 audit had not yet been performed and that "the quality review partner would not initiate his work until the engagement partner signed off on it." Tr. 232. Stewart testified that he believed that the engagement quality review should have been completed before the audit report for both audits was released, but conceded that such review was not completed. Tr. 242.

On September 27, 2013, Hitor filed an amended Form 10-K to, among other things, "correct" "errors" in the audit report. Ex. J-51 at 4. The corrected audit report, in the name of the Harris Firm and dated April 15, 2013, stated, "We have audited the accompanying balance sheets of Hitor Group, Inc. (A Development Stage Company) as of December 31, 2012 and December 31, 2011, and the related statements of income, stockholders' equity and cash flows for the period then ended, and the period July 15, 2005 (inception) to December 31, 2012." *Id.* at 6. It further stated, "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." *Id.* Both the original and corrected audit reports opined that Hitor's financial statements "present fairly, in all material respects, the financial position of Hitor Group, Inc.," and both contained an explanatory paragraph noting that there was substantial doubt about Hitor's ability to continue as a going concern. Exs. J-44 at 10, J-51 at 6. There is nothing in the record to indicate that Stewart played any role in the issuance of the corrected audit report or in Hitor's filing of the amended Form 10-K.[9/]

IV.

The OIP charged that in the 2011 reaudit and the 2012 audit of Hitor, Stewart violated PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, and Rule 3200T, *Interim Auditing Standards*, by:

- failing to exercise due professional care and skepticism, in violation of AU § 150, *Generally Accepted Auditing Standards*, and AU § 230, *Due Professional Care in the Performance of Work*;

- failing to obtain sufficient appropriate audit evidence for certain significant items in Hitor's 2011 and 2012 financial statements to support the opinion expressed in the audit report on those financial statements, in violation of Auditing Standard No. 15, *Audit Evidence*;

- failing to perform procedures to address insufficient appropriate audit evidence concerning relevant assertions, in violation of Auditing Standard No. 14, *Evaluating Audit Results*;

[9/] Several years after the period at issue here, the SEC revoked the registration of Hitor's securities for failure by the company to file any periodic reports since September 2014. *See Bill the Butcher, Inc., Hitor Grp., Inc., Xun Energy, Inc.*, SEC Rel. No. 34-79653, 2016 WL 7406287 (Dec. 22, 2016).

- failing to adequately plan the audits, in violation of Auditing Standard No. 9, *Audit Planning*;

- failing to adequately supervise engagement personnel, in violation of Auditing Standard No. 10, *Supervision of the Audit Engagement*;

- failing to identify and assess the risks of material misstatement, in violation of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*; and

- failing, to the extent Stewart performed sufficient or adequate audit procedures that were alleged to be insufficient or inadequate, to ensure that those procedures were documented, in violation of Auditing Standard No. 3, *Audit Documentation*.

V.

The Division of Enforcement and Investigations bears the burden of proving by a preponderance of the evidence that Stewart engaged in an act or practice, or omitted to act, in violation of PCAOB rules and auditing standards, as charged in this case. PCAOB Rule 5204; *see* Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. § 7215(c)(4); PCAOB Rule 5300(a). Our findings are based on a *de novo* review of the record. PCAOB Rules 5460(c), 5465. We apply the rules and standards as they existed at the time of the alleged violations, based on "what the accountant knew or should have known at the time an action was taken or a decision was made." *See, e.g., Kevin Hall, CPA*, SEC Rel. No. 34-61162, 2009 WL 4809215, *7 (Dec. 14, 2009).

PCAOB rules require that associated persons of registered public accounting firms comply with applicable auditing and related professional practice standards in connection with the audits of issuers. PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*; PCAOB Rule 3200T, Interim Auditing Standards. Stewart was aware of his obligation to perform the 2011 reaudit and 2012 audit in accordance with PCAOB standards. Tr. 68-69. Those standards require that an auditor exercise due professional care and maintain an "independence in mental attitude," including a "questioning mind and a critical assessment of [the] audit evidence" throughout the audit. AU §§ 150.02, 230.01, .07.

PCAOB standards also require the engagement partner to "supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached." AS No. 10. Supervising an audit engagement requires the engagement partner to: (a) inform engagement team members of their responsibilities, including the objectives of the procedures to be performed, the nature, timing, and extent of procedures to be performed, and matters that could affect the procedures to be performed or the evaluation of the results of those procedures; (b) direct engagement team members to bring significant accounting and auditing issues to the engagement partner's attention; and (c) review the work of the engagement team to evaluate whether the work was performed and documented, the objectives of the procedures were achieved, and the results of the work support the conclusions reached. *Id.* at ¶ 5.

Under PCAOB standards, the engagement partner may "seek assistance from appropriate engagement team members" in planning the audit, but he or she remains "responsible for the engagement and its performance" and is, accordingly, "responsible for planning the audit." AS No. 9 ¶ 3. In audit planning, an auditor should "establish an overall audit strategy that sets the scope, timing, and direction of the audit" and develop and document an audit plan that describes, among other things, "[t]he planned nature, timing, and extent of tests of controls and substantive procedures." *Id.* at ¶¶ 8-10.

In connection with the planning and performance of an audit, the auditor should also identify and assess the risks of material misstatement in the financial statements. AS No. 12. These procedures should be "sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures." *Id.* at ¶ 4. Required risk assessment procedures include conducting a discussion among "all engagement team members who have significant engagement responsibilities, including the engagement partner," concerning the risks of material misstatement and inquiring with management about the risks of material misstatement that exist. *Id.* at ¶¶ 49-55.

PCAOB standards require that the auditor plan and perform procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the audit opinion. AS No. 15 ¶ 3. Such evidence is "appropriate" if it is both "relevant and reliable in providing support for the conclusions on which the auditor's opinion is based." AS No. 15 ¶ 6. Reliability, in turn, "depends on the nature and source of the evidence and the circumstances under which it is obtained," and in general, the reliability of audit evidence is greater when "obtained from a knowledgeable source that is independent of the company" and or, if obtained from the company itself, "when the company's controls over that information are effective." AS No. 15 ¶ 8. PCAOB standards require that, if an auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. AS No. 14 ¶ 35. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, the auditor should express a qualified opinion or a disclaimer of opinion. *Id.*

The standards also require the auditor to document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. Such documentation must demonstrate that the audit work was in fact performed and contain sufficient information to enable an experienced auditor to understand the nature, timing, extent, and results of procedures performed (and who performed them), the evidence obtained, and the conclusions reached. AS No. 3 ¶ 6.

Referring collectively to his work on both the 2011 reaudit and 2012 audit, Stewart has stated that "this was not a perfect audit" and "there's a number of things that could be done better on this" but that he "certainly would not intentionally violate a PCAOB rule." Tr. 234, 236. He testified that he believed he exercised due professional care, exercised appropriate levels of professional skepticism, and performed audits that produced sufficient evidence to support the audit report. Tr. 234-35. In support of his petition for review, Stewart not only argues that "[h]is work was sufficient for planning and supervising the Reaudit and the Audit" because "the lack of complexity and the small size of the Client meant that less was required," which was the focus of his briefing to the hearing officer, but also lists various steps he claims to have taken in planning and supervising those audits. R.D. 41, Opening Brief (Br.) 3-7. He raises numerous objections to the initial decision's findings regarding discrepancies and inconsistencies in the work papers and asserts that "sufficient audit evidence" was secured "as required by the pertinent" auditing standards. Br. 9-13, 20-22. Stewart argues that "the sanctions" ordered by the initial decision are "excessive and oppressive and not otherwise appropriate to the findings or the basis on which the Sanctions were imposed," focusing particularly on the civil money penalty, which he characterizes as "a purely punitive action" because he does not intend to participate in any more issuer audits and should not be "penalized" for having requested a hearing instead of settling the proceeding against him. Br. 23; R.D. 44, Reply Brief (Reply) 4-5.

The Division contends that Stewart "consistently fails to…take any responsibility for his own work—or his demonstrated lack of work—as the engagement partner for the Audits" and "fails to identify any evidence, or any legal argument, that would undermine the Hearing Officer's findings and conclusions." R.D. 42, Opposition Brief (Opp.) 1-2. Instead, the Division argues, Stewart has submitted a "laundry list of actions he purportedly took as the engagement partner" in satisfaction of his obligations to plan and supervise the audit that were merely "logistical, not substantive," "inadequate to fulfill his obligations under PCAOB auditing standards," or "not supported by the evidentiary record." Opp. 5-6. The Division contends that Stewart's "arguments as to why the audit evidence obtained was sufficient to support unqualified opinions on Hitor's 2011 and 2012 financial statements" are "irrelevant and unsupported." Opp. 9. The Division urges us to affirm the sanctions ordered by the hearing officer as supported by the record and by relevant precedent. Opp. 20-24.

We find that the Division proved by a preponderance of the evidence that Stewart fell far short of fulfilling his fundamental responsibilities to exercise due care, to plan and supervise the audits, and to obtain sufficient appropriate evidence to support the audit opinion. As discussed in detail below, Stewart violated multiple PCAOB auditing standards. His arguments to the contrary are unsupported by the record, applicable auditing standards, or applicable law.

A. Stewart failed to adequately plan, assess risks for, and supervise both audits.

The record overwhelmingly establishes that Stewart by design played an all but non-existent role as engagement partner on the Hitor audits. By his own account, Stewart understood that Harris expected him to have almost no involvement in planning the audits in question or supervising Staff Employee's work, as Harris believed Staff Employee was nearly ready to become a partner at the Harris Firm. Stewart may have fulfilled Harris's expectations, but in doing so he fell far short of fulfilling his obligations as an engagement partner under PCAOB auditing standards. *See, e.g.,* AS No. 10 ¶ 3 (stating that the "engagement partner is responsible for the engagement and its performance" and therefore "is responsible…for compliance with PCAOB standards"); App. A of AS No. 10; *Robert D. Potts, CPA*, SEC Rel. No. 34-39126, 1997 SEC LEXIS 2005, *2 (Sept. 24, 1997) (engagement partner has "primary responsibility for assuring the accuracy of these audits"), *aff'd*, 151 F.3d 810 (8th Cir. 1998).

Under AS No. 9, the engagement partner is specifically responsible for planning the audit. Yet Stewart played no role at all in establishing an audit strategy or plan for either the 2011 reaudit or the 2012 audit. He says he held "no formal planning session" with Staff Employee, but there is no evidence Stewart had any meaningful involvement in any planning—formal or informal. Tr. 49. Although AS No. 9 permits the partner to "seek assistance" from appropriate audit team members in planning the audit, Stewart did more than "seek assistance" from Staff Employee: he left the planning function entirely to Staff Employee, despite the fact that Stewart had no prior experience working with him. Stewart knew that Staff Employee was going to use generic audit programs for the audits at issue, but Stewart provided no instructions or guidance regarding their use, instead allowing Staff Employee himself to determine "which procedures in those pre-printed forms were applicable and which ones weren't applicable." Tr. 40.

The efforts Stewart makes in his brief to characterize himself as taking an active role in planning the Hitor audits are wholly unsupported by the record and contrary to his own unequivocal testimony. *See, e.g.*, Tr. 40, 49, 75, 90, 179-80, 184, 188-90. Stewart now asserts that he "arranged a conference call for April 10, 2013 with Mr. Harris to discuss his work for the Harris Firm." Br. 4. But the only support he offers for this claim is an email sent from Harris to Stewart informing Stewart that "the two audits that we need you to sign off as partner in charge" were nearly complete—well beyond the planning stage—to which Stewart merely responded, "I will be able to review the files this week. I will call tomorrow." Ex. J-33. Stewart also claims that he "consulted with the Harris Firm prior to his engagement…to determine if there were any changes in the Client's operations that might necessitate a change in the previously used audit program for this Client" and that Stewart "approved using an audit program consistent with that used in prior years." Br. 3-4. But the only support Stewart cites for these assertions is his own testimony that he was simply "aware" that Harris and Staff Employee "were going to use generic [audit] programs and that's a common procedure." Tr. 38, 48. There is no evidence in the record that Stewart analyzed the client's "operations" or its impact on the audit, provided any input on any aspect of the audit plan, or took any action to "approve" the audit plan, except for his after-the-fact sign-off on Staff Employee's completed work papers. Stewart's total abdication of his audit planning responsibilities violated AS No. 9.

Stewart also failed in the 2011 reaudit and the 2012 audit to identify and assess the risks of material misstatement in Hitor's financial statements, in violation of AS No. 12. He testified that he did not discuss with Staff Employee the risks of material misstatement presented by the audits. Tr. 75, 184. Nonetheless, Stewart claims that he appropriately sought "assistance in fulfilling his responsibilities from engagement team members" and that "appropriate Client inquiries were made." Br. 19. But the only evidence of any such "Client inquiries" is the "Fraud Awareness Questionnaire" and the "Analysis of Internal Controls for the year ended December 31, 2012" forms that Staff Employee collected from Hitor management, ostensibly designed to help "identify types of potential weaknesses in internal control and factors that affect the risk of fraud, and…consider the effect on the planning of [the] audit" (Ex. J-10 at 243, 245). Stewart knew that Staff Employee did nothing with the collected information but place a copy of the two completed forms in each work paper file, and Stewart himself did nothing with the information. Ex. J-10 at 243-45; Tr. 91-92. It is unclear from either document whether management intended its responses to apply to one or both audits or whether the information provided was actually relevant to circumstances as they existed in only 2012, or 2011 and 2012, and there is no evidence that Stewart or Staff Employee even considered the question at the time or applied the information to any assessment of risk.

Although these two forms are the only evidence that the engagement team made any client inquiries to assess the risks of material misstatement, Stewart attempts to minimize their importance by suggesting that "the Client's size…eliminat[ed] the need to conduct much of an assessment of internal controls." Br. 6-7. But in doing so he ignores the fact that, on their face, the forms were designed to elicit information bearing broadly on fraud risk factors, not just potential weaknesses in internal controls.[10]

And more significantly, there is no evidence that Stewart ever considered or discussed with Staff Employee how the company's lack of internal controls might impact the conduct of the audits, or that Stewart was even aware that, despite the lack of internal controls, the work papers for the 2011 reaudit and the 2012 audit reflected an assessment that control risk—the risk that a material misstatement will not be prevented or detected on a timely basis by the company's internal controls—was low. *See* Ex. J-10 at 246, 248; Ex. J-17 at 222-23; Tr. 93; AS No. 8 ¶ 7.b ("Control risk is a function of the effectiveness of the design and operation of internal control."). Stewart's abdication of his responsibilities to assess the risks of material misstatement violated AS No. 12.

Stewart also violated AS No. 10 by failing to supervise Staff Employee in any meaningful way. Stewart's "supervision" of Staff Employee during planning and performance of the audit was limited to being copied on emails between Staff Employee and Hitor management, to which Stewart made no response. After Staff Employee's audit work was completed, Stewart's involvement was limited to spending about four hours reviewing the work papers prepared by Staff Employee before signing off on the issuance of an unqualified audit opinion for both of the audits.

Despite admitting repeatedly at the hearing that he understood from the inception of his role as engagement partner that the plan "was to have [Staff Employee] do as much as possible in his audit without direct supervision from me" (Tr. 49; *see* Tr. 39-40 (describing his review as "very minimal"), 180-81, 72-73, 217-18), Stewart now claims to have performed a list of tasks that demonstrates his active involvement in planning of the audits and supervision of assistants in accordance with PCAOB standards (Br. 4-5).

[10] As explained in note 6 above, certain responses on the Analysis of Internal Controls form relating to whether Hitor had any employees conflicted with statements in the company's Form 10-K, and the Form 10-K itself was internally inconsistent on this point. *Compare* Ex. J-10 at 245 and J-17 at 221 with Ex. J-10 at 329 and Ex. J-44 at 4-5. Stewart, in arguing that the information reported by management on Form 10-K "is a subsequently arising fact unknown to [him] at the time [of the audits]" (Br. 18), ignores that the draft Form 10-K containing the inconsistencies is, in fact, part of the work papers he claims to have reviewed. Ex. J-10 at 329; R.D. 30; Br. 5. Given the abundant evidence that Stewart and Staff Employee did practically nothing to assess the risks of material misstatement, we note Stewart's failure to notice the inconsistencies between the so-called Analysis of Internal Controls and the Form 10-K merely to highlight that overall lack of audit work and that, as discussed below, Stewart failed to exercise due care in his review of the work papers Staff Employee prepared.

But the substantive steps he claims to have taken either did not occur according to the record evidence or were inadequate to fulfill his obligations under PCAOB standards.

First, the list of tasks Stewart cites confirms, rather than refutes, his failure to fulfill his obligations under PCAOB standards. For example, Stewart asserts that he "assured that the Client signed an engagement letter," "coordinated with audit staff so that they knew when his review of the final work papers would be completed," "provided direction to [Staff Employee] as to the format of the audit opinion," and "notified the Harris Firm staff when his review of the final audit work papers was complete." Br. 4-5. Such tasks do not come close to addressing the substantive requirements of any of the standards discussed, including AS No. 9, AS No. 10, and AS No. 12.

Second, claims in Stewart's brief that he took certain actions are not borne out by the record. For example, according to the brief, he "approved the selection and use of an [sic] commercially available, and widely used audit program." Br. 4, 7. But the testimony cited for that proposition does not support it. That testimony merely reflects Stewart's admission that it was Staff Employee, not Stewart, who "determined which procedures in those pre-printed forms were applicable and which ones weren't applicable." Tr. 40. That testimony further confirms that Stewart gave no instruction to Staff Employee about the "nature, timing, and extent of procedures" to be performed, as he was required to do under AS No. 10 ¶ 5(a)(2).

Stewart's brief also claims he "assured appropriate audit information was solicited from" Hitor and that Hitor "provided necessary information." Br. 4. But the joint exhibits cited for this proposition consist of nothing more than emails on which Stewart was copied, and do not show any work on his part to satisfy himself that Staff Employee had the information and documentation necessary to proceed with the audit. *See* Exs. J-28 (email from Staff Employee to Hitor, copying Stewart), J-30 (same), J-31 (same).

Stewart next points to Exhibits J-32 and J-34 to claim he "assured that the Client facilitated access by the audit team to necessary bank account statements and other information needed to complete the audit" and that "questions about the value of the Client's inventory were asked and answered by the Client." Br. 4. But those exhibits, too, are emails between other persons on which he was merely copied. *See* Ex. J-32 (email between Harris and Hitor); Ex. J-34 (email between Harris and Staff Employee).

Similarly, Stewart claims he "assured that both the Harris Firm audit team and the external quality review auditor had access to the audit file" and "assured that there was no disagreement between either the Harris Firm audit team and the quality review auditor as to necessary adjustments to the Client's financial statements or questions raised in the audits about the Client's financial statements," citing certain emails on which Stewart was copied. Br. 5 (citing Exs. J-36, J-37). Neither these emails nor contemporaneous emails in Ex. J-35 support Stewart's assertions, for the engagement quality review is not mentioned and the person Stewart identified as the engagement quality reviewer is not even copied. *See* Tr. 106-07 (identifying accountant who prepared the financial statements); Tr. 242 (identifying auditor who was to serve as the engagement quality reviewer). More than that, these emails undercut Stewart's claims of responsible involvement; they document that Staff Employee was informing the accountant who prepared Hitor's financial statements that, for example, certain accounts "look[] like a mess that needs to be reconciled" and other assertions were from an "unknown source," without indicating any effort by Stewart—who made no reply to the emails—to find out if, or how, these concerns were ever addressed. Ex. J-36.

Also, the belated, unsubstantiated claim in Stewart's brief that he "assured that there was no disagreement between either the Harris Firm audit team and the quality review auditor" flies in the face of the evidence that no such review was ever conducted and that Stewart never concerned himself with finding out if any such review had been done or whether any issue raised in that review required attention. Stewart's attempt before us to depict himself as playing an active role in the audits is undermined by his lack of any inquiry, under the circumstances, into whether Harris was working on the audits. *See* pages 5-6 above. In short, there is no support in the record for Stewart's claims that he took any meaningful action to fulfill his role as engagement partner in planning or supervising the audits under AS Nos. 9, 10, and 12.

Finally, Stewart argues he is not liable for any failure to supervise Staff Employee because he "met the requirements applicable to him" under Sarbanes-Oxley Act Section 105(c)(6), 15 U.S.C. 7215(c)(6). Br. 15. This defense fails for multiple reasons.

First, Stewart misconceives that provision. Section 105(c)(6)(B) provides for an affirmative defense in certain circumstances to a proceeding brought under Section 105(c)(6)(A). Section 105(c)(6)(B) applies only when the Board proceeds under Section 105(c)(6)(A), which the Board is not required to do to sanction an engagement partner under Section 105(c)(4) for violating auditing standards that govern supervision by engagement partners. Here, the Board did not proceed under Section 105(c)(6)(A).

Specifically, PCAOB auditing standards contain requirements related to the supervision of engagement team members that address staffing the audit, supervision of audit work by the lead partner and others on the engagement team, and review of the work of assistants on the team. *See* AU § 230.06, AS No. 10. Section 105(c)(4), under which this proceeding was brought, authorizes the Board to sanction firms and their associated persons for violations of those supervision standards. The Board did so, for example, in *Deloitte & Touche LLP*. PCAOB Rel. No. 105-2007-005 (Dec. 10, 2007) at 5 & n.4 (settled order censuring firm and imposing civil money penalty for, among other things, failure to staff an engagement in accordance with AU § 230.06). Section

105(c)(6) extends that authority, providing a basis for imposing sanctions on individuals beyond the engagement team for failures reasonably to execute supervisory responsibilities related to a person who commits a violation of auditing standards.

Section 105(c)(6)(A) provides a distinct enforcement tool for the Board to use in circumstances where an individual who has not been reasonably supervised has violated certain laws, rules, or professional standards. In such circumstances, Section 105(c)(6)(A) affords the Board broad authority to impose sanctions on a firm or an individual for failing reasonably to supervise, without regard to whether any rules or standards specifically governing supervision were violated,[11/] and without limiting the sanctionable supervisory individuals only to those on an audit engagement team.

Second, even if Section 105(c)(6)(B) were relevant, Stewart has failed to establish the elements of the affirmative defense that subsection sets out. Specifically, subsection B states that no supervisory person can be found to have failed reasonably to supervise under subsection A if all of these conditions are met: (1) the individual reasonably discharged the supervisory duties placed on him or her by the firm's procedures; (2) he or she had no reasonable cause to believe the firm's procedures were not being complied with; and (3) the firm's procedures comply with applicable PCAOB rules and would reasonably be expected to prevent and detect the violation. Stewart makes no attempt to establish either that the Harris Firm established procedures reasonably expected to prevent or detect violations of PCAOB standards or that he reasonably discharged his duties or obligations incumbent under any such procedures. Nor could he do so on this record.

[11/] Section 105(c)(6) addresses supervision in terms that are "similar to those that apply to broker-dealers under section 15(b)(4) of the Securities Exchange Act of 1934." S. Rep. No. 107-205 at 11, 49. Securities Exchange Act Section 15(b)(4)(E), 15 U.S.C. 78*o*(b)(4), and its companion provision, Section 15(b)(6), 15 U.S.C. 78o(b)(6), "create liability" for broker-dealers and their associated persons when "inadequate supervision is coupled with a violation by [a] supervisee," while sanctions for direct violations of the securities laws are authorized by other portions of the statute. *See, e.g., Collins v. SEC*, 736 F.3d 521, 524, 527 (D.C. Cir. 2013) (affirming sanctions against supervisor of registered representative and describing respondent as "within the class of persons for whom the statute was designed—an individual supervising persons subject to securities laws"); *Thomas C. Bridge*, SEC Rel. No. 34-60736, 2009 WL 3100582 (Sept. 29, 2009) (imposing sanction under Exchange Act Section 15(b) on registered representative for violations of the antifraud provisions of the securities laws and imposing sanctions under Securities Exchange Act Sections 15(b)(4)(E) and 15(b)(6) on representative's supervisor for failing to reasonably supervise him).

Third, Stewart did not raise his Section 105(c)(6) argument until his brief on review to us. *See* Br. 15 (raising argument for first time); R.D. 13 (Stewart's answer, asserting no affirmative defense and making no reference to Section 105(c)(6)). Having failed to raise any such defense in a timely manner, Stewart waived it. *See* PCAOB Rule 5421(c) ("any" matter "constituting an affirmative defense shall be asserted in the answer"); *Mark E. Laccetti, CPA*, PCAOB File No. 105-2009-007, at 83-84 (Jan. 26, 2015) (holding that respondent waived affirmative defense by not timely raising it), *aff'd*, SEC Rel. No. 34-78764, 2016 WL 4582401 (Sept. 2, 2016), *appeal filed on other grounds*, *Laccetti v. SEC*, No. 16-1368 (D.C. Cir. Oct. 31, 2016); *see also, e.g., Laurie Jones Canady*, SEC Rel. No. 34-41250, 1999 WL 183600, *12 (Apr. 5, 1999). For all of these reasons, we reject Stewart's attempt to evade liability for his violations of PCAOB auditing standards by resort to an inapplicable legal defense.

B. Stewart failed to obtain sufficient appropriate evidential matter to support material assertions in Hitor's financial statements and to exercise due professional care and skepticism.

Stewart's only discernible contribution to the reaudit and audit of Hitor's financial statements was to receive certain emails and review the work papers prepared by Staff Employee. Yet this contribution in itself failed to meet PCAOB standards, as Stewart's cursory review of Staff Employee's work fell far short of an exercise of due professional care or of a "critical assessment of [the] audit evidence." AU §§ 150.02, 230.01, .07. In receiving the emails and reviewing the work papers for both the 2011 reaudit and the 2012 audit, Stewart missed or ignored a series of glaring signs that audit conclusions regarding material assertions in Hitor's financial statements were not supported by audit evidence sufficient to provide a reasonable basis for the audit opinion. Despite never having worked with Staff Employee before these audits and knowing nothing about Staff Employee's qualifications as an auditor except that he was a CPA whom Harris hoped to promote to partner, Stewart signed off on every aspect of the audits without asking a single question about the obvious deficiencies and discrepancies in the work papers.

Specifically, in reviewing the 2011 reaudit work papers, Stewart failed to notice, or ignored, serious deficiencies in the documented work done to support the amounts Hitor reported as assets (cash and inventory) and as liabilities (convertible notes payable, deposit, and notes payable). Cash represented more than 59% of Hitor's reported current assets, yet Stewart failed to notice or question the fact that Staff Employee deviated from the audit plan and relied on unverified, client-prepared documents to test cash balances, without performing any procedures to test the balances as of the actual (year-end) date reported on the financial statements. Inventory represented over 40% of the company's total reported assets, and although Staff Employee requested documentation from management to support the valuation of the inventory for 2011, Stewart never asked whether such documentation was received, and never questioned the absence of any such support in the work papers, despite knowing the value of the inventory would be reduced to zero in the 2012 financial statements. Convertible notes payable of $400,000, a deposit of $150,000, and notes payable of $81,270 represented 78% of Hitor's total reported liabilities. Despite being copied on an email in which Staff Employee told management that two of the three accounts were "old and I have no idea what for," Stewart signed off without comment or question on work papers that did not document any procedures done to test whether these items were fairly stated. And Stewart's sign-off notwithstanding, the work papers for the 2011 reaudit contained no lawyer response letter at all and a management representation letter that pertains only to Hitor's financial statements for 2012, not 2011.

In reviewing the 2012 audit work papers, Stewart failed to notice, or ignored, obvious deficiencies in the documented work done to support the amounts Hitor asserted as assets (inventory, prepaid expenses, and an investment in Hitor Poland) and as liabilities (convertible notes payable and notes payable). Hitor reduced its reported assets by 38% when it wrote off its inventory in 2012. Yet Stewart, who was aware that Staff Employee had not yet ascertained management's "stance" on the inventory write-off as late as April 3, failed to question the lack of any documentation in the work papers supporting the existence or valuation of the inventory or considering the question whether the write-off was appropriately taken in 2012 instead of in the prior year. Nor did Stewart question whether the write-off had any impact on the relevant assertions of notes payable, one of which was "secured" by this now valueless inventory. Prepaid expenses represented 47% of Hitor's reported current assets, yet the only work Staff Employee documented to test this assertion was to locate a related contract that was unsigned and bore no indication of how the agreement for services supported the $57,617 Hitor reported for prepaid expenses on its balance sheet. Even though Hitor reported an "Investment in Hitor Poland LLC" that represented 16% of its total reported assets, Stewart failed to notice or question that the invoice supposedly supporting this assertion did not support the entire amount or reference Poland at all. Finally, Hitor's reported convertible notes payable and notes payable represented 65% of its current liabilities, yet Stewart failed to notice or question the lack of documentation in the work papers of any procedures done to test the reported figures.

The work papers patently demonstrate that insufficient work was done to gather evidence to support a series of relevant assertions of significant accounts in the financial statements. Stewart's failure to notice this, or, if he did notice it, his failure to question it in any way, violated PCAOB standards requiring that he obtain sufficient appropriate audit evidence to support the audit opinion, perform procedures to address insufficient appropriate audit evidence concerning relevant assertions of significant accounts, and exercise due professional care, including professional skepticism. AS Nos. 14, 15; AU §§ 150, 230. None of the defenses Stewart offers is meritorious.

First, Stewart asserts generally that Staff Employee obtained sufficient audit evidence with respect to "inventory, bank balances, investment in Hitor Poland and cash balances, notes payable, deposits, and liabilities with respect to the Reaudit and the write-off of inventory on the balance sheet for December 31, 2012" and Stewart "appropriately relied on [Staff Employee's] work." Br. 21. As his only support for this broad statement, Stewart cites Exhibit J-6 (with no reference to any specific page), which is a set of work papers prepared in the original 2011 audit, and claims he "appropriately relied on the 2011 audit records in conducting the Reaudit." Br. 21. We reject Stewart's claim of reliance on audit documentation from the original 2011 audit. His argument represents nothing more than an "after-the-fact rationalization" that is not supported by contemporaneous evidence. *See, e.g., Wendy McNeeley, CPA*, SEC Rel. No. 34-68431, 2012 WL 6457291, *11 (Dec. 13, 2012).

Stewart specifically and unequivocally testified that he did not review Exhibit J-6 at the time he conducted the 2011 reaudit and the 2012 audit. Tr. 117. There is no evidence that he reviewed at that time the other exhibit from the work paper file of the original 2011 audit, Exhibit J-11. *Id.* Nor is there evidence that he evaluated the work on the original 2011 audit.[12/]

[12/] Stewart, rather than identifying any contemporaneous evidence that he actually relied on work papers from the original 2011 audit, instead cites AU § 315, *Communications Between Predecessor and Successor Auditors,* and asserts that he was "rightfully entitled to rely on information obtained in the original 2011 audit to inform the Reaudit and the Audit both as to audit procedures and planning." Br. 14. But he concedes that he "was not technically a successor auditor as defined by AU Section 315" and, at best, contends that AU § 315 could apply here only as "illustrative of good audit policy." Br. 14. While we take no position on that contention, we note that the standard would not help Stewart in any event. He ignores that AU § 315 provides that "the information obtained from [] inquiries [of the predecessor auditor] and any review of the predecessor auditor's report and working papers is not sufficient to afford a basis for expressing an opinion. The nature, timing, and extent of the audit work performed and the conclusions reached in the reaudit are solely the responsibility of the successor auditor performing the reaudit." AU § 315.15. And to the extent Stewart is attempting to validate, by reference to AU § 315, his assertion that he had no choice but to rely on the 2011 inventory count done by Harris because "you can't go back in time and do that inventory count for the 2011 [reaudit]" (Tr. 120-21), that argument again fails on its own terms. Although AU § 315.20 recognizes that the successor auditor "generally will be unable to observe inventory or make physical counts at the reaudit date," it provides that the auditor instead "should, if material, observe or perform some physical counts of inventory at a date subsequent to the period of the reaudit, in connection with a current audit or otherwise, and apply appropriate tests of intervening transactions." There is no evidence any such work related to Hitor's inventory was done in the Stewart-led audits.

Stewart also implies that overall his audit work was rigorous and complete because he not only reviewed the work papers for the 2011 reaudit and 2012 audit but also "the general ledger," maintained by Hitor as QuickBooks files that Stewart now contends should have been, but were not, made available at the hearing. Br. 9, 11, 13, 21. Stewart's argument ignores the fact that he unequivocally represented that Exhibits J-10 and J-17 are his complete sets of work papers for the audits. If Stewart believed that Hitor's general ledger—the client's accounting records—contained his audit work, he could have presented those files as exhibits at the hearing, but he failed to do so.[13/]

In any event, reading a general ledger, no matter how carefully or intently—without adequately testing any of the accounts, transactions, or journal entries—cannot provide sufficient appropriate audit evidence. *See, e.g.,* AS No. 13 ¶¶ 8, 36–37 (the auditor is required to perform substantive procedures to test the relevant assertions of the significant accounts in order to address the risk of material misstatement); AS No. 15 ¶ 10 (when using information produced by the company as audit evidence, the auditor is required to "[t]est the accuracy and completeness of the information" where there are no internal controls over its accuracy and completeness and must "[e]valuate whether the information is sufficiently precise and detailed for purposes of the audit"). There is no evidence that Stewart performed any such testing, nor has he attempted to describe what that testing entailed. If he had performed such work, it should have been, but was not, documented in the work papers. *See, e.g., McNeeley,* 2012 WL 6457291, *11, *13 ("'[T]he absence of work papers [is] evidence that the audit team did not devote substantial, if any, effort to review the areas in question.'"); *Gregory M. Dearlove*, SEC Rel. No. 34-57244, 2008 SEC LEXIS 223, *32 n.39 (Jan. 31, 2008) (stating that work papers "are ordinarily the foundation on which support for audit conclusions is demonstrated" and that "[w]e consider the absence of work papers to be evidence that

[13/] Stewart's brief implies that he sought to introduce, or consult, some additional client files at the hearing that could have assisted in his defense but was prevented from doing so, claiming that, "[d]uring the hearing, through no fault of Mr. Stewart, neither the investigators nor the Hearing Officer could open the QuickBooks electronic file provided by Mr. Stewart; they relied on hard copies of only those specific documents that the investigators asked Mr. Stewart to provide to them." Br. 9 (citing Tr. 172:3-21); *see* Br. 11, 12, 13 (all citing to Tr. 172:3-21). There is no support for this *post hoc* argument. As Stewart explained in the cited testimony, during the investigation he provided the Division with an electronic copy of his work papers that turned out to be unreadable, and so he provided the Division with a second copy that was readable. Stewart has never suggested that this second file was somehow incomplete or corrupted. All exhibits in this case were introduced as joint exhibits. Stewart brought no other materials to the hearing nor sought to introduce any other materials. He stipulated without reservation or exception that two joint exhibits (Exhibits J-10 and J-17) constituted complete copies of his work papers.

the audit team did not devote substantial, if any, effort to review the areas in question"), *aff'd*, 573 F.3d 801 (D.C. Cir. 2009). Stewart's unsupported allusion to a "general ledger review" does nothing to mitigate his failure to devote sufficient due care to his review of the audit work papers.

In addition to these broad arguments, Stewart also offers several arguments targeted more specifically at his evaluation of certain assertions in the financial statements. These we reject as well, for the reasons set out below.

1. 2011 cash

Stewart argues that he was not required to confirm cash balances in the reaudit and that Staff Employee instead appropriately applied "supplemental methods that were allowable and acted in accordance with the standards set out in AU-C 700." Br. 9, 10, 20-21. Stewart's argument is ill-supported, for it relies on AICPA standards that do not apply in PCAOB audits such as those at issue here. It is also misplaced, for we do not find that he violated PCAOB auditing standards for failing to perform any specific procedure in reviewing Hitor's cash balances, but rather for failing to obtain sufficient appropriate evidence—by any valid procedure—to support the cash balance reported on Hitor's financial statements. The work papers indicated, via Staff Employee's initials, that Staff Employee "[r]equest[ed] confirmation as of the audit date for the bank account(s) selected" and "[d]ocument[ed] the items selected for confirmation and retain[ed] returned confirmations." Ex. J-10 at 104. In fact, Staff Employee did not do this, as is apparent from the work papers. Instead, he used bank statements he received from the client (not directly from the bank) to trace the "book balance" to "bank statement" at "various intervals throughout the year." Ex. J-10 at 107. But, as noted, Staff Employee did not perform any procedures (whether through confirmations, tracing the balance to bank statements, or other procedure) to test the cash balances as of year-end, which were the balances actually reported on the financial statements.

Moreover, although Stewart tries to frame the issue in terms of having no responsibility to "authenticate" the client's bank statements (Br. 21), PCAOB auditing standards require that auditors obtain sufficient appropriate audit evidence to provide a reasonable basis for their opinion. AS No. 15 ¶ 4. The appropriateness of that evidence is measured by its relevance and its reliability. *Id.* at ¶ 6. Its reliability, in turn, "depends on the nature and source of the evidence and the circumstances under which it was obtained." *Id.* at ¶ 8. Here, the bank statements were obtained from the company, not from an independent source, and, in general, "[e]vidence obtained directly by the auditor is more reliable than evidence obtained indirectly." *Id.* Stewart understood through email correspondence from Harris to Hitor that Staff Employee was having trouble gaining access to the statements, and the work papers plainly showed that Staff Employee had at least planned to acquire confirmations but did not ultimately do so for unknown reasons. Under these circumstances, Stewart's failure to display any semblance of "a questioning mind and a critical assessment of audit evidence" (AU § 230.07) or to perform any procedures at all to evaluate whether the bank statements were sufficient and appropriate as evidence for purposes of the audits violated AU § 150, AU § 230, AS No. 14, and AS No. 15.

2. 2011 inventory

Stewart contends that "[t]he documentary evidence at the hearing established that there was an inventory observation with respect to the 2011 audit," which "was relied on in the Reaudit." Br. 12 (citing Ex. J-11 at 55, Tr. 120-24). Stewart's claim that an inventory observation from the original 2011 audit was considered in the 2011 reaudit not only lacks support in the work papers and is contrary to the admission in his answer that he "failed to perform any procedures, and failed to ensure that [Staff Employee] performed any procedures, regarding the existence or valuation of [Hitor's] inventory [as of December 31, 2011]" (Ans. 3 ¶ 15; OIP 5 ¶ 15), but also, at best, his claim amounts to unquestioning acceptance of Harris's count and valuation of inventory, without performing any work to substantiate, confirm, or test those conclusions in the reaudit (*see, e.g.*, Tr. 123-25). The mere existence of an inventory observation in the work papers of the original 2011 audit led by Harris does not explain or excuse the lack of meaningful audit work on inventory in the Hitor audits led by Stewart. Management's ultimate determination to write off the inventory on the 2012 financial statements should have raised some question about the support for the value asserted on the 2011 financial statements, which Stewart never addressed. For all of these reasons, Stewart failed to obtain sufficient appropriate evidential matter to support Hitor's financial statement assertions related to inventory and failed to exercise due professional care, including professional skepticism.

3. 2011 management representation letter

The 2011 reaudit work papers contain only a copy of a management representation letter that applies to the 2012 audit (and was also included in the 2012 work papers). In his defense, Stewart makes two contradictory arguments. First, he argues, without elaboration or explanation, that he was "not required by AU Section 333 or AU Section 337 to secure a management representation letter for the Reaudit separate from the management letter with respect to the [2012] Audit." Br. 20. Second, he argues that he "was not required to maintain the Client's Management representation letter, as record retention was the responsibility of the Harris Firm." Br. 18-19. The plain language of AU § 333.05 contradicts Stewart's claim that no letter was necessary for 2011 if one was secured for 2012, for it provides that "[w]ritten representations from management should be obtained for all financial statements and periods covered by the auditor's report." To the extent Stewart is suggesting that he had in fact secured a letter for 2011 that complied with PCAOB standards and was included in the work papers but cannot be held accountable for its loss, that argument is inconsistent with his specific and unreserved admission that the record contains his complete work papers. R.D. 30. We decline to credit either facet of Stewart's internally inconsistent defense.

4. 2012 inventory

Stewart failed to consider the appropriateness of management's decision to write down to zero the inventory in 2012 (versus 2011). His brief offers in defense that "[t]he decision that the inventory be written-off in 2012 and not 2011 was an appropriate exercise of discretion based on changed facts between 2011 and 2012." Br. 12. He claims that "in light of the continuing absence of sales in 2012 and a change in the Client's business focus (J-17 at 309-332), the audit team reported to the Client the inventory was impaired by the end of 2012." Br. 11. But there is no support in the record for Stewart's claim; the 2012 work papers do not document a change in Hitor's business focus (nor does Stewart explain what that is), and the engagement team played no role in reporting any impairment to management.

5. 2012 notes payable

Stewart claims he "had no responsibility to answer the legal question of whether the write-off of inventory in 2012 had an impact on the note payable secured by the inventory. … The audit opinion emphasized the auditor's doubts as to the Client's ability to pay by including comments questioning whether the entity was a going concern." Br. 22; *see* Br. 23; *see also* I.D. 28-29. Stewart misstates his audit responsibilities. He was responsible for assessing whether the write-off of the inventory value had any impact on the relevant assertions of notes payable, one of which was "secured by inventory." The inclusion of a going concern paragraph in no way diminishes the auditor's duties to perform an audit under PCAOB standards. *See* AU §§ 508.07, .10, .11.

6. 2012 "investment" in Hitor Poland

As noted, Stewart failed to notice or question that the invoice supposedly supporting Hitor's asserted investment in Hitor Poland LLC did not support the entire amount or even reference Poland or Hitor Poland LLC. He tries to re-cast this simple issue by claiming that "the issue in the hearing with respect to the advance of funds to Hitor Poland LLC was not validation that an advance of funds occurred but whether the expenditure in question should have been expensed rather than capitalized." Br. 21-22. But Stewart's characterization of the issue is not supported by the transcript, was not what was charged, was not discussed or alluded to at the hearing or in briefing, and is not a basis for any finding of violation. Stewart's argument is thus irrelevant.

*   *   *

Based on the foregoing, the Board finds that the Division proved by a preponderance of the evidence that Stewart violated PCAOB Rules 3100 and 3200T by failing to comply with AU § 150, AU § 230, and AS Nos. 9, 10, 12, 14, and 15, in the 2011 reaudit and 2012 audit of Hitor's 2011 and 2012 financial statements.

VI.

Sarbanes-Oxley Act Section 105(c)(4) authorizes the Board to impose "such disciplinary or remedial sanctions as it determines appropriate," subject to certain limitations, on registered public accounting firms or associated persons of such firms if the Board "finds, based on all of the facts and circumstances," that the firm or person has violated PCAOB rules and auditing standards. 15 U.S.C. 7215(c)(4). With respect to a proceeding against an associated person, such as here, Section 105(c)(5) specifies that a suspension, bar, or limitation on the activities or functions of such person, as well as a civil money penalty within a certain range (in excess of $120,000 and not more than $900,000 for the pertinent period) "for each violation," "shall only apply" to "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard" or to "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." 15 U.S.C. 7215(c)(5); 17 C.F.R. 201.1003, Table I. In this context, recklessness "represents an 'extreme departure from the standards of ordinary care, … which presents a danger' to investors or the markets 'that is either known to the (actor) or is so obvious that the actor must have been aware of it.'" *S.W. Hatfield, CPA,* SEC Rel. No. 34-69930, 2013 SEC LEXIS 1954, *77 (July 3, 2013). Applicable PCAOB auditing standards provide the standard of care for assessing the auditor's conduct. *Id*.

A. Stewart recklessly, if not intentionally, violated PCAOB auditing standards.

PCAOB standards require auditors to adequately plan the audit and to properly supervise any assistants, to exercise due professional care, to maintain an attitude of professional skepticism, and to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion with respect to the financial statements under audit. Auditors may reasonably differ in how they might tailor a particular engagement to satisfy these fundamental requirements, but Stewart's near-total abdication of these responsibilities is by definition an extreme departure from the standard of care.

At the outset, Stewart's arrangement to replace Harris as engagement partner but to have only the most "minimal" involvement in the audits (*see, e.g.*, Tr. 39-40) effectively removed the vital role of the engagement partner from the audit process. The Commission has described the "purpose of auditor rotation" as "bringing a fresh perspective to the audit" designed to promote "auditor independence" and "critical thinking." *See Dearlove,* 2008 SEC LEXIS 223, *7, *21; *see also* S. Rep. No. 205, 107th Cong., 2d Sess. (June 26, 2002) (Senate Report accompanying Sarbanes-Oxley Act) at 21 (recognizing the "strong benefits that accrue for the issuer and its shareholders when a new accountant 'with fresh and skeptical eyes' evaluates the issuer"). Neither that purpose nor the purpose of having an engagement partner in the first place is served if the rotation results in no one at all performing the role of engagement partner. By prearrangement, Stewart did next to nothing on the two Hitor audits, ceding all responsibilities for planning and performing the audits—this despite Stewart never having worked with Staff Employee before nor having any understanding of his qualifications, other than that he was a CPA. Stewart's participation essentially amounted to a four-hour review of the work papers for the two audits beginning only the day before issuance of the audit report. Prior to his sign-off, Stewart admittedly had no contact with Hitor management, did not ask Staff Employee any questions, and performed no procedures to obtain further audit evidence, despite problems that were obvious from the work papers. Although the arrangement between Stewart and Harris profited Stewart, who obtained a fee of some $3,000 for about four hours of his time (Tr. 51-54, 239-40), and the Harris Firm, which obtained $37,500 in total audit fees for the 2011 Hitor reaudit and the 2012 Hitor audit (*see* Tr. 244; Ex. J-44 at 25-26), the deal badly disserved investors' interests.

For example, the emails between Staff Employee and Hitor management, on which Stewart was copied but took no action, cried out for Stewart to devote careful attention to the audit work. That correspondence made plain that Staff Employee was having difficulty in performing particular tasks. Staff Employee noted in an April 13 email that certain line items in the company's 2012 trial balance were "new" with an "unknown source," while others were "old and I have no idea what for," and still others were "a mess that needs to be reconciled." Ex. J-36. Stewart, however, did nothing to find out whether or how Staff Employee was able to satisfactorily resolve these issues.

The work papers themselves contained so many deficiencies and inconsistencies that Stewart knew, or was reckless in not knowing, that little or no audit work was performed or audit evidence obtained to evaluate whether Hitor's financial statements were fairly stated. For the 2011 reaudit, over 40% of Hitor's assets and almost 80% of its liabilities were subject to no audit work whatsoever, and another 59% of Hitor's assets (namely, cash) was not supported by sufficient appropriate audit evidence. For the 2012 audit, over 38% of the assets and over 65% of the liabilities had been subject to essentially no procedures at all. The audit evidence supporting another 16% of assets (namely, the investment in Hitor Poland) was also facially deficient.

Stewart's minimal, all but nonexistent role in the audits, coupled with evidence that such lack of involvement was by prearranged design, means that Stewart either deliberately intended to circumvent PCAOB auditing standards or that he had the reckless view that the standards permitted such a role. His failure to respond to the numerous red flags during the audits, involving fundamental shortcomings in the audit work on accounts representing significant portions of Hitor's balance sheet, was "an egregious refusal to see the obvious or investigate the doubtful by any measure." *Hatfield*, 2013 SEC LEXIS 1954, *80 (*quoting Barrie C. Scutillo*, SEC Rel. No. 34-48238, 2003 WL 21738818, *9 (July 28, 2003) (finding auditor's failure to obtain sufficient competent audit evidence to be reckless)). At a minimum, such conduct was reckless. *Id. at* *82, *85-*86 (auditors' "repeated and nearly complete failure[] to perform adequate audit procedures created obvious, significant, and ongoing risk to investors," constituting "reckless or knowing" failure to adhere to PCAOB standards).

Stewart objects to such findings because "there were no obvious issues of fraud" at Hitor. Br. 22. But an issuer's financial statements need not be fraught with signs of possible fraud before the auditor is subject to sanctions for failing to conduct the audit with appropriate rigor. Whether or not there are "obvious issues of fraud" (*id.*), the auditor "must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud" by "reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence" (AS No. 8 ¶ 3) (footnote omitted), thus subjecting the financial statements to "the rigors of independent and objective investigation and analysis" (*McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005)). In other words, the issue here is whether the auditors performed their audit in compliance with applicable auditing standards. *Hatfield*, 2013 SEC LEXIS 1954, *85-*86 & n.145, *87-*88 n.148; *accord Gale Moore, CPA*, PCAOB File No. 105-2012-004 at 40 n.11 (Aug. 23, 2016); *cf. Gately & Associates*, SEC Rel. No. 34-62656, 2010 SEC LEXIS 2535, *50 (Aug. 5, 2010) (rejecting attempt by respondents, who "note that their conduct did not involve fraud or deceit," to "downplay the seriousness of their conduct"). Where, as here, the audit work is so deficient on its face, the auditor could not have been unaware of the danger to investors and the markets that the client's financial statements were unreliable. *See, e.g., Hatfield*, 2013 SEC LEXIS 1954, *82 (auditor's "cavalier approach to the auditing standards" presented obvious risk of harm to investors). Stewart is not "shielded" from liability even if "the audited financial statements [may have been] fortuitously…not materially misleading.'" *Dearlove*, 2008 SEC LEXIS 223, *49 n.51 (citation omitted); *see Bollt & Shapiro*, SEC Rel. No. AS-82, 1959 WL 2695, *6 (Jan. 28, 1959) ("That registrant's balance sheet was not complex and its accuracy and completeness have not been questioned in this proceeding, does not either cure or reduce the importance of the [auditing standards violations at issue].").

We further reject Stewart's related claim that in the 2012 audit, the auditors "disputed" the "value of inventory" calculated by management and "required" it to be written off, demonstrating professional skepticism and "that appropriate action was taken by the auditors based on their investigation into issues of doubt." Br. 22. There is no evidence in the record of any "dispute" over this issue, much less that the "dispute" was resolved through any insistence by any auditor. Harris simply sent an email to management in April 2013 asking without elaboration for its "stance" on the inventory, to which no response exists in the record. Ex. J-32. Indeed, contrary to Stewart's current claim in his brief, Stewart testified that the accountant who prepared the financial statements—not the auditors—proposed to write off the inventory in 2012. Tr. 203. Stewart has offered no basis for understanding his conduct as anything less than a series of extreme departures from fundamental auditing principles that created an obvious risk to the investing public. Accordingly, we conclude that, for purposes of our sanctioning authority under Section 105(c)(5) of the Sarbanes-Oxley Act, Stewart's misconduct was reckless, if not intentional.

B. Stewart's violations call for the imposition of strong sanctions.

In determining the sanctions that are appropriate for Stewart's violations, we consider the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, to carry out our statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports. *See* Sarbanes-Oxley Act Section 101(a), 15 U.S.C. 7211(a); *see also* Section 101(c)(5), 15 U.S.C. 7211(c)(5) (in identifying duties of Board, referring to objective "to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof" or "otherwise to carry out this Act, in order to protect investors, or to further the public interest"). Stewart's sanctions arguments do not specifically address an associational bar, a limitation on activities, or a censure, but instead focus on a civil money penalty.[14/]

Stewart's wide-ranging abdication of his audit responsibilities in the two Hitor audits is properly met with strong sanctions. *See Scutillo*, 2003 SEC LEXIS 1777, *58 ("[r]eckless failures to comply with auditing standards…'jeopardize the achievement of

[14/] *See* Br. 22-24 (in "Objections to Sanctions," only specific mention of sanctions other than civil money penalty is in paragraph trying to create a context in which a $25,000 civil penalty is supposedly excessive); Reply 2-5 ("In this case, the imposition of the bar, the restriction and the censure are more than sufficient to protect the public's interest without levying the additional monetary penalties….[These other sanctions] fully protect the users of public company audits….As was the case in *Hatfield*, the additional sanction of a steep monetary penalty is not necessary to protect investors."), 7 (stating in conclusion that Board "should decline to impose the sanctions as recommended and overturn the Initial Decision," after having made the narrow point in the preceding sentence that "we urge the Board to reverse the monetary sanction in it[s] entirety, because this sanction is not necessary to protect the interests of the investing public").

the objectives of the securities laws and can inflict great damage on public investors'") (quoting *Touche Ross & Co., Inc. v. SEC*, 609 F.2d 570, 581 (2d Cir. 1979)). He failed to meet his professional obligations on two different audits in multiple, fundamental respects, despite his 35 years of experience in the profession. *See Hatfield*, 2013 SEC LEXIS 1954, *91 (imposing permanent bar on "experienced auditors, who nevertheless knowingly, intentionally, and repeatedly failed to exercise the basic professional skepticism and due care that are the touchstones of an auditor's responsibilities"); *Moore*, PCAOB File No. 105-2012-004 at 48, 50 (imposing bar with leave to petition to associate after two years for reckless auditing standards violations where respondent was "an experienced auditor," which "should have helped equip her to understand her auditing responsibilities"); *see also Dearlove*, 2008 SEC LEXIS 223, *109, *111 (imposing a bar from appearing or practicing before the SEC with leave to seek reinstatement after four years for having "violated fundamental principles of auditing" despite "lengthy audit experience"); *James Thomas McCurdy, CPA*, SEC Rel. No. 34-49182, 2004 SEC LEXIS 221, *29 (Feb. 4, 2004) (auditor's "lengthy experience makes his failure to conduct the audit in accordance with applicable professional standards particularly troublesome"), *aff'd*, 396 F.3d 1258 (D.C. Cir. 2005). Stewart's arrangement with Harris to do minimal work on the audits and extreme lack of diligence during the audits betrays an approach to auditing issuers that is "perfunctory at best" (*McCurdy*, 396 F.3d at 1264) and created an "obvious, significant, and ongoing risk to investors" who were entitled to believe that the financial statements had been audited with due professional care (*Hatfield*, 2013 SEC LEXIS 1954, *85-*86). The more serious a violation, the stronger the inference that it will be repeated. *See generally Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004).

Stewart, in the face of overwhelming, uncontradicted evidence, insists that his minimal and deeply flawed conduct in the two audits satisfies PCAOB standards and characterizes this case as merely that each audit "was not a perfect audit" and "there's a number of things that could be done better." Tr. 234-36. That does not begin to describe the problem. His demonstrated lack of appreciation for the nature, gravity, and extent of his failures strongly suggests that, if given the chance, he would repeat them. *See, e.g., ZPR Inv. Mgmt. Inc.*, SEC Rel. No. 40-4249, 2015 WL 6575683, *29 (Oct. 30, 2015) ("failure to recognize the wrongfulness of…conduct is relevant to our consideration of the public interest and demonstrates a risk of future violations"), *aff'd in relevant pa*rt, 861 F.3d 1239, 1255 (11th Cir. 2017)); *Michael C. Pattison, CPA*, SEC Rel. No. 34-67900, 2012 SEC LEXIS 2973, *41 (Sept. 20, 2012) (same).

Stewart contends that he "poses no substantial risk of harm to those who rely on the integrity of audit reports" because the Hitor audit report contained a going concern paragraph and thus "appropriately communicated the negative financial condition of the Client." Br. 23. But he readily admitted that Hitor had received such a paragraph "every year" since it went public in 2006, which he stated is "fairly common for development stage companies." Tr. 61; *see* Ex. J-15 at 9. This undermines his suggestion that investors were sufficiently alerted to anything more particular about Hitor's financial condition for the years at issue here. Indeed, the audit report did not merely communicate the auditor's "substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time" (AU § 341.02); it also expressed an unqualified opinion (*see* AU § 508), which was subject to reliance in its own right.

Stewart's assumption that investors, market professionals, and issuers can have no meaningful interest in the reliability of detailed information about a public company's financial condition, and in whether there was a proper audit, so long as there is a going concern paragraph is baseless and places issuers with such an audit report and their investors in an even more precarious position. *See, e.g., Scutillo*, 2003 WL 21738818, *8 ("insertion of a going concern qualification in [audit] report did not justify [an asset] valuation" for which the auditor "had neither persuasive evidence nor sufficient competent evidential matter to support"); AU § 341.12 n.4 ("[n]othing in this section" about a going concern paragraph "is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties"); *cf. Hatfield*, 2013 SEC LEXIS 1954, *87 (auditors "were not freed from the many auditing requirements they inexcusably ignored simply because [they might have required the company to] increase[] its reserve for bad debt"). Compared to an issuer not in financial distress, an issuer in financial distress may well pose additional risks that need to be addressed in an audit. *See, e.g*., *Peat, Marwick, Mitchell & Co.*, SEC Rel. No. AS-173, 1975 WL 160439, *19 (July 2, 1975) (faulting auditor for failing to apply increasing procedures and "great[er] degree of caution, particularly since during the time in question [issuer] was experiencing financial difficulties and the prior auditors had identified some of the problems"); *Dearlove*, 2008 SEC LEXIS 223, *104 ("As audit risk increases, so does the need for care and skepticism."). Stewart's argument betrays a thoroughly erroneous view of his auditing responsibilities that underscores the need for strong sanctions to encourage him and others similarly situated to take those responsibilities seriously, no matter the size or condition of the client whose financial statements are under audit. *See Dearlove*, 2008 SEC LEXIS 223, *20, *78-79 (auditing standards "apply to audits of all sizes and all levels of complexity").

In briefing, Stewart additionally asserts that he poses no future threat to investors because, at "near[ly] seventy years old," he is "retiring," "has transitioned all of his clients to other CPA firms," and so he "will not be accepting new public company clients nor will he be issuing any new opinions for public companies." Reply 3-4. In contrast, at the hearing, he could only state under oath that he planned to retire soon but the "transition is going slower than [he] had anticipated." Tr. 244. He claimed that "definitely within two years I'll be out and [another CPA will] take over." *Id*. But stated intentions of leaving, and even voluntary absences from, issuer audit work are not enforceable and do not establish that the person will not resume such work. *See Mark*

E. Laccetti, CPA, PCAOB File No. 105-2009-007 at 96 (Jan. 26, 2015), *aff'd*, SEC Rel. No. 34-78764, 2016 WL 4582401 (Sept. 2, 2016), *appeal filed on other grounds*, *Laccetti v. SEC*, No. 16-1368 (D.C. Cir. Oct. 31, 2016). While Stewart states he is no longer auditing issuer clients, he nevertheless maintains an active CPA license with the State of Washington through June 2019 "to practice public accounting." *See* note 2 above. Even if his license should lapse, that does not preclude his return to auditing public companies. *See* Wash. Admin. Code 4-30-124 (reinstatement procedures); *see also Russell Ponce*, SEC Rel. No. 34-43235, 2000 SEC LEXIS 1814, *47 (Aug. 31, 2000) (noting that, although respondent "ha[d] not renewed his CPA license," he could resume auditing by seeking reinstatement with state authorities). Stewart does not contend that he anticipated entering into the special arrangement to audit Hitor, which yielded him roughly $3,000 for about four hours of his time, nor is there evidence that, at only 67, he would not similarly find attractive and entertain discrete issuer audit projects even if he did retire from general practice.[15/]

Based on the facts and circumstances of this case, we find that Stewart poses too great a risk to investors to be in a position to continue auditing public companies until appropriate sanctions provide a reason to believe he can and would do so in compliance with PCAOB standards. We accordingly find it appropriate in the public interest to bar Stewart from association with a registered public accounting firm. By design and execution of the 2011 Hitor reaudit and the 2012 Hitor audit, Stewart effectively eliminated the engagement partner from the audit process, thereby demonstrating an approach to auditing that is antithetical to fundamental precepts. *See, e.g.*, AU § 150 (first standard of fieldwork); AS No. 10 ¶ 3 (stating that the "engagement partner is responsible for the engagement and its performance" and therefore "is responsible…for compliance with PCAOB standards"); AS No. 10, App. A (engagement partner has "primary responsibility for the audit"). Such conduct undercuts public trust and "confidence…in the integrity of the financial reporting process" and in the reliability of financial information needed "[f]or the market to operate efficiently—indeed, for it to operate at all." *See McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005) ("Investor confidence is bolstered by the knowledge that public financial statements have been subjected to the rigors of independent and objective investigation and analysis."); *Marrie*

[15/] In addition, we may take official notice that in a June 27, 2017 Form 8-K available on the SEC's EDGAR database, In Media Corp. referred, in announcing a change of auditors, to its "Board's understanding that [George Stewart, CPA] intends to cease, or at least greatly curtail, providing public company accounting work as part of his practice" (emphasis added); attached was a November 29, 2016 letter from Stewart stating, "We agree with the statements concerning our Firm in such Form 8-K." *See* https://www.sec.gov/Archives/edgar/data/1399488/000107878217001244/f8k091117_8k.htm (last visited on Dec. 12, 2017).

v. SEC, 374 F.3d 1196, 1200 (D.C. Cir. 2004); *Philip L. Pascale*, SEC Rel. No. 34-51393, 2005 SEC LEXIS 639, *47 (Mar. 18, 2005); *see Hatfield*, 2013 SEC LEXIS 1954, *90 ("[R]egulators and the investing public…'rely heavily on [auditors] to assure corporate compliance with federal securities law requirements and disclosure of accurate reliable information.'").

The initial decision deemed it appropriate to bar Stewart from association with a registered public accounting firm with the proviso that he could petition the Board to associate after three years but would be restricted for two additional years from associating as an engagement partner or an engagement quality reviewer on any issuer audit, from exercising authority to sign a registered public accounting firm's name to an audit report for any issuer, and from consenting to an issuer's use of a previously issued audit report. I.D. 38. Although Stewart's sanctions arguments appear to be specifically directed at the civil money penalty, part of our review, as noted in our briefing schedule order, is to "determine what sanctions, if any, are appropriate in this matter." *See* R.D. 40 (citing PCAOB Rule 5460(d)); *see generally, e.g., vFinance Investments, Inc.*, SEC Rel. No. 34-62448, 2010 WL 2674858, *14 (July 2, 2010) (noting, in connection with the point that "[i]n granting Respondents' petition for review, we determined on our own motion to review 'what sanctions, if any, are appropriate in this matter,'" that "[w]hen Congress grants an agency the responsibility to impose sanctions to achieve the purpose of a statute, 'the relation of remedy to policy is peculiarly a matter for administrative competence'") (quoting *Butz v. Glover Livestock Comm'n Co., Inc.* 411 U.S. 182, 185 (1973) (internal citations and quotation omitted)).

Given the gravity of Stewart's misconduct, the likelihood of recurrence, and the need to protect investors demonstrated by the record, we determine that he should not be granted leave to petition to associate with a registered public accounting firm in any capacity until after five years. The sanction imposed in the initial decision does not fully reflect the implications of the findings of violations for the determination of Stewart's state of mind and the level of sanction. The bar and proviso we impose, for Stewart's prearranged abandonment of any meaningful effort to carry out his auditing responsibilities in each of two separate audit years, is consistent with the range of sanctions imposed in other adjudicated auditing cases.[16/]

[16/] *See, e.g., Moore,* PCAOB File No. 105-2012-004 at 48 (barring auditor from association with a registered public accounting firm, with proviso that she may petition to associate after two years and that weight will be given in considering such petition to completion by her of 50 hours of professional education, and restricting her activities for two additional years for misconduct in one audit); *Laccetti*, PCAOB File No. 105-2009-007 at 96 (barring auditor, with leave to petition to associate after two years, and imposing an $85,000 civil penalty, for misconduct in one audit); *S.W. Hatfield, CPA*, PCAOB File No. 105-2009-003, at 9-10, 22, 25, 27 (Feb. 8, 2012) (permanent bar

It is also appropriate to censure Stewart to further impress upon him the egregiousness of his violations and the seriousness of his auditing responsibilities. A censure additionally serves to '"notif[y] the public of [Stewart's] past misconduct' even after the terms of the other sanctions have been fulfilled." *Moore*, PCAOB File No. 105-2012-004 at 51 (quoting *Salvatore F. Sodano*, SEC Rel. No. 34-59141, 2008 WL 5328801, *3 (Dec. 22, 2008)); *see, e.g., Philip L. Spartis*, SEC Rel. No. 34-64489, 2011 WL 1825026, *13 (Dec. 1, 2010) ("censures…alert the public, including other [regulatory authorities], of the unacceptability of [the actor's] conduct").

Further, Stewart's conduct warrants the imposition of a $25,000 civil penalty. In the Sarbanes-Oxley Act, Congress underscored the seriousness with which it viewed auditor misconduct by authorizing the Board to impose "disciplinary or remedial sanctions" that include, for the period at issue here, civil money penalties of up to $900,000 per violation against a natural person, as well as a temporary or permanent bar from association with any registered public accounting firm. *See* Section 105(c)(4) & (5), 15 U.S.C. 7215(c)(4) & (5); 17 C.F.R. 201.1001, Table I (statutory inflation adjustment); *see Free Enterprise Fund v. PCAOB*, 561 U.S. 477, 485 (2010) (observing panoply of sanctions available in PCAOB disciplinary proceedings); *see also* S. Rep. No. 107-205 at 10-11 (describing Sarbanes-Oxley Act as authorizing "a full range of sanctions," including "'meaningful,'" "substantial" civil money penalties). A $25,000 civil penalty is well within the authority granted to the Board under the statute and, for many reasons, is appropriate under the circumstances. *See, e.g., Laccetti*, PCAOB File No. 105-2009-007 at 96-97 ($85,000 civil penalty imposed for violations in single audit was both "at the low end of the range of the heightened civil penalties authorized by the Sarbanes-Oxley Act for each violation involving the level of [reckless or repeatedly negligent] misconduct found here and less than the maximum civil money penalty authorized by the statute for a single violation not even reaching that threshold").[17/]

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determined to be appropriate for auditor misconduct in three audits for two issuers, including admittedly "roll[ing] over" when an SEC filing was made that the auditors "knew was false and misleading" by issuer that the auditors believed was "a 'scam'" and believed was managed by persons who had "no intent to run [a] company" but "want[ed] to get filings into the marketplace as quick as possible" to facilitate a "pump and dump" scheme), *aff'd*, 2013 SEC LEXIS 1954; *see also Dearlove*, 2008 SEC LEXIS 223, *111 & n.120 (canvassing sanctions in contested Rule 102(e) auditor cases from bars with leave to seek reinstatement after one to five years to permanent bars and barring auditor with leave to seek reinstatement after four years for misconduct in one audit).

[17/] *See also, e.g., PTR, Inc. v. SEC*, 159 Fed. App'x 338, 344 (3d Cir 2005) (unpublished) (sustaining SEC's determination that a FINRA fine and suspension "were reasonably necessary to impress upon [respondents] the necessity of strict compliance

Stewart demonstrated a reckless, if not intentional, disregard of fundamental auditing standards. His misconduct created a significant risk of substantial harm to investors that necessarily flows from audit reports founded on his extreme departures from PCAOB standards. A $25,000 civil penalty, together with the other sanctions we impose, will encourage more rigorous compliance with auditing standards by Stewart, if he seeks to associate with a registered public accounting firm in the future, and by other issuer auditors. Even if his present intention were to retire permanently from any public company audit work, the record shows that he accepted some $3,000 to do next to nothing on two issuer audits at a late stage of his career. Tr. 239-40. The need to deter such behavior is high, both specifically and generally. An auditor with Stewart's years of experience should not be incentivized to act so deleteriously during issuer audits because he or she will soon be exiting the field and may believe an associational bar would have little or no impact on him or her. We have calibrated this sanction to fit the particular facts here, even if "imposing a larger penalty in this case might provide an even greater deterrent against similar [misconduct]." *See R.E. Bassie & Co.*, SEC Rel. No. AAE-3354, 2012 SEC LEXIS 89, *3, *51-*52 (Jan. 10, 2012) ("a civil penalty of $75,000 appears sufficient to have a deterrent effect on a firm such as Bassie's," a sole proprietorship); *cf. FCS Sec.*, SEC Rel. No. 34-64852, 2011 WL 2680699, *9 (July 11, 2011) (sustaining FINRA's sanctions determination that considered the respondent brokerage firm's "small size and lack of business" as one factor in reaching the appropriate level of fine to impose).

Stewart contends that a $25,000 civil penalty is impermissibly "punitive" "when considered with" nonmonetary sanctions that he asserts "require his ceasing to serve on audits for public companies." Br. 23-24; Reply 4. In fact, Stewart appears to urge the Board to only impose an associational bar and a censure. *See* Reply 3-5, 7. As

with Exchange rules"); *David Adam Elgart*, SEC Rel. No. 34-81779, 2017 WL 4335050, *8 (July 28, 2017) (holding that fine and suspension will "impress upon [respondent] the need to take his responsibilities in this regard more seriously in the future"); *Steven P. Sanders*, SEC Rel. No. 34-40600, 1998 WL 741105, *12 (Oct. 26, 1998) (determining that "a substantial fine is necessary here to impress upon [respondent] and others in the industry the seriousness with which we view such supervisory failures"); S. Rep. No. 107-205 at 11 (noting generally that the "breadth of [the legislation's] sanctions is intended to encourage flexible and appropriate action, designed to correct if possible"); *cf. SEC v. Lipson*, 278 F.3d 656, 664 (7th Cir. 2002) (in rejecting a challenge to a stiff civil money penalty imposed by the district court on a corporate executive, explaining that the imposition of harsher sanctions is justified to bring a wrongdoer "to his senses" where "[t]he evidence against [him] was overwhelming" and yet he "insist[s] in the face of it that he is a shorn sheep" and is "the injured party" and thus "demonstrates by his obduracy the likelihood that he will repeat" the misconduct).

discussed, however, Stewart's age, asserted intentions, and the associational bar we determine to be appropriate for his violations do not necessitate a conclusion that he will never be in a position again to audit public companies, as his argument against the civil money penalty assumes. Even a permanent bar does not preclude reentry. *See* PCAOB Rule 5302(c) (Board rule governing applications by barred individuals to associate); *cf. Rizek v. SEC*, 215 F.3d 157, 161 (1st Cir. 2000) (citing SEC Rule of Practice 193, 17 C.F.R. 201.193, and noting that "the term 'permanent bar' is more than a bit of a misnomer. It does not literally mean that the sanctioned person may never reenter the securities industry."). For the reasons we have discussed, the civil money penalty is warranted in combination with the other sanctions we impose here.

Additionally, Stewart claims he is improperly being "penalize[d]" for litigating this case, while others who have settled may have received lighter sanctions. Reply 5-7. Specifically, Stewart asserts he cannot receive any greater sanctions than the sanctions to which the Harris Firm and Harris agreed when they settled a partly related disciplinary action brought against them by the Board. Brief 23-24; Reply 1-2. According to Stewart, any suggestion by the Division or the initial decision that he could receive a "monetary sanction" that "exceed[s] that imposed on his employer (Harris) violates the Bylaws and Rules of PCAOB," citing PCAOB Rule 5205(c)(4) for the point that a "rejected offer [of settlement] shall not constitute a part of the record in any proceeding against the person making the offer" and citing comments to the rule for the point that "the content of settlement negotiations would not be introduced as evidence in Board proceedings." Reply 6. Stewart's argument misses the mark.

In the first place, the record does not include any offer of settlement (rejected or otherwise) from Stewart (*see* R.D. 21b; R.D. 37), and no such offer, even if it existed, has played any part in our decision of this case. As to the settlement with the Harris Firm and Harris, it was Stewart who brought that up as relevant to the appropriate sanction in this proceeding, raising it as an argument in his post-hearing brief to the hearing officer. R.D. 34 at 24 ("Notwithstanding this list of unrelated cases, the Division makes no reference to the one settled disciplinary matter that is directly relevant to the facts in this action-the settled disciplinary action against the Harris Firm. *See Harris & Gillespie CPAs*, PLLC, Rel. No. 105-2015-011 (PCAOB June 16, 2015).").[18/]

[18/] Not only did Stewart cite a settled, rather than an adjudicated, case, which is problematic in itself, but also he selectively cited that one matter, making no mention of settled disciplinary matters such as, for example, *Randall A. Stone, CPA*, PCAOB Rel. No. 105-2014-007 (July 7, 2014) (sanctions included a $50,000 civil penalty for certain violations of PCAOB standards in connection with one audit and a consent to incorporate by reference the audit report for that audit in a Form S-8 registration statement); *Ernst & Young LLP*, PCAOB Rel. No. 105-2012-001 (Feb. 8, 2012) (sanctions included a $50,000 civil penalty on lead engagement partner for violations in

Yet Stewart does not compare the particulars of his conduct to the particulars of the conduct addressed by that settlement, and, in elsewhere insisting that no civil money penalty is warranted for his own conduct, ignores that the settlement included a $15,000 civil penalty. Stewart also ignores that "'the appropriate sanction depends on the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings.'" *Hatfield,* 2013 SEC LEXIS 1954, *95 (citation omitted). There is no obligation to make sanctions uniform. *Kornman v. SEC*, 592 F.3d 173, 188 (D.C. Cir. 2010); *Geiger*, 363 F.3d at 488. Comparisons between litigated and settled cases are particularly problematic because "[l]itigated cases typically present a fuller, more developed record of facts and circumstances for purposes of assessing appropriate sanctions than do settled matters" (*Pattison*, 2012 SEC LEXIS 2973, *49 (citing *Nassar and Co., Inc.*, n.37 (1978), *aff'd*, 600 F.2d 280 (D.C. Cir. 1979)) and "settled cases take into account pragmatic considerations such as the avoidance of time-and-manpower-consuming adversary proceedings" (*Hatfield*, 2013 SEC LEXIS 1954, *95 (those "'who offer to settle may properly receive lesser sanctions than they otherwise might have"); *accord, e.g., Orkin v. SEC*, 31 F.3d 1056, 1067 (11th Cir. 1994); *Amato v. SEC*, 18 F.3d 1281, 1284 (5th Cir. 1994); *Gary M. Kornman*, SEC Rel. No. 34-59403, 2009 WL 367635, *9 (quoting *Stonegate Sec., Inc.*, SEC Rel. No. 34-44933, 2001 WL 1222203, *4 (Oct. 15, 2001)), *aff'd*, 592 F.3d 173, 188-89 (D.C. Cir. 2010)). Here, we have made extensive findings about Stewart's misconduct and carefully considered the public interest, based on a full record, specific to this case, that Stewart was given every opportunity to develop.

In sum, the sanctions we impose in this case serve to protect against Stewart's demonstrated capacity for the conduct at issue and to encourage more rigorous compliance by him and others with their responsibilities under PCAOB auditing standards. The sanctions protect investors and further the public interest, and none of Stewart's arguments, and none of the circumstances presented by this case, suggest that the sanctions are in any way excessive or oppressive. *See* 15 U.S.C., 7217(c)(3).

three audits); *Thomas J. Linden, CPA*, PCAOB Rel. No. 105-2009-004 (Aug. 11, 2009) (sanctions included a $75,000 civil money penalty on engagement partner for violations in two audits); *Christopher E. Anderson, CPA,* PCAOB Rel. No. 105-2008-003 (Oct. 31, 2008) (sanctions included a $25,000 civil money penalty on engagement partner for violations in one audit).

VII.

As set forth above, we have found that the Division proved by a preponderance of the evidence that Stewart violated PCAOB rules and auditing standards, as charged in the OIP, and we have determined appropriate sanctions for those violations.

An appropriate order will issue.[19/]

By the Board.

[19/] We have considered all of the parties' contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

PCAOB
Public Company Accounting Oversight Board

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of George W. Stewart, Jr., CPA,

Respondent

PCAOB File No. 105-2015-016

ORDER IMPOSING SANCTIONS

December 15, 2017

On the basis of the Board's opinion issued this day it is

ORDERED that George W. Stewart, Jr. is barred from associating with any registered public accounting firm, provided that, after five (5) years, he may petition for Board consent to associate with a registered public accounting firm; and it is further

ORDERED that George W. Stewart, Jr. is censured; and it is further

ORDERED that George W. Stewart, Jr. shall pay a civil money penalty in the amount of $25,000 by (a) United States postal money order, certified check, bank cashier's check, or bank money order, (b) made payable to the Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies George W. Stewart as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the

date the Commission lifts the stay imposed by Sarbanes-Oxley Act Section 105(e), 15 U.S.C. 7215(e).

By the Board.

Phoebe W. Brown
Secretary

December 15, 2017

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Melissa K. Koeppel, CPA	PCAOB File No. 105-2011-007
	FINAL DECISION
Respondent	December 29, 2017

Appearances

Mark W. Porter, Esq., and Michael W. Davis, Esq., Washington, DC, for the Division of Enforcement and Investigations

Gary F. Bendinger, Esq., Linton J. Childs, Esq., and Brian S. Shull, Esq., Sidley & Austin LLP, for Respondent Melissa K. Koeppel

I.

In this disciplinary proceeding, Respondent Melissa K. Koeppel is charged with violating PCAOB rules and auditing standards in annual audits she led of an issuer's financial statements for the fiscal years ending June 30, 2006, 2007, and 2008. At issue as to each audit is the testing of the issuer's journal entries for potential material misstatement due to fraud and audit work on particular issuer accounts into which journal entries flowed: analytical procedures relied on as substantive tests of net sales; support for the reliability of internal reports provided by the issuer for use in audit testing of net sales, sales allowances, accounts receivable, and inventory; and particular testing of accounts receivable for the latter part of the 2008 audit period, all against the background of certain perceived limitations or deficiencies in the issuer's internal systems and processes, which generally were not tested in the audits. In these areas, Koeppel is charged with failing to exercise due professional care, including professional skepticism, failing to obtain sufficient audit evidence and assurance, and other violations. Ultimately, the issuer restated its financial statements for fiscal years 2008 and 2009, principally to reflect adjustments relating to what it described as fraudulent, unauthorized transactions by members of its accounting department occurring from at least fiscal year 2005 through December 2009 and totaling about $31.5 million over that period, when the issuer reported $22.3 million in total net income.

After a hearing, the hearing officer issued an initial decision dismissing the charges. The initial decision found that the Division of Enforcement and Investigations had proven by a preponderance of the evidence that the performance of some, but not other, work in the 2006, 2007, and 2008 audits "did not fully comply with applicable PCAOB auditing standards," but held that the Division had not "established a legally cognizable basis" for imposing sanctions on Koeppel, who had not personally performed, and was not charged with failing to plan, delegate, or supervise, that audit work. The Division seeks Board review, challenging certain of the initial decision's findings about the audit work performed, the decision's ultimate holding that no valid theory of violation was presented, and its rejection of the requested sanctions and arguing that Koeppel committed violations and should be sanctioned. As sanctions, the Division seeks a bar from associating with a registered public accounting firm, with leave to petition to associate in three years; a $150,000 civil penalty; and "requirements for additional professional education and training that are specifically targeted (1) on the design and performance of journal-entry testing (100 hours), and (2) on the design and performance of substantive analytical procedures (100 hours), given the nature of the violations in this case." Koeppel cross-petitions for review of the decision's adverse findings about the audit work performed. And the parties oppose each other's petitions.

Based on our *de novo* review, in light of the briefs and oral argument, we find that Koeppel violated PCAOB rules and auditing standards in certain of the respects charged. She did so by failing to exercise due professional care, including professional skepticism, and failing to obtain sufficient audit evidence, among other violations. We further find that this conduct constituted repeated instances of negligence and calls for the imposition of strong sanctions. As we explain in Section VI(B) below, the appropriate sanctions for us to impose at this stage, under the unique circumstances of this case, are a two-year limitation on Koeppel's activities and a censure.

II.

In our determination, the Board, on August 16, 2011, following a properly authorized investigation, appropriately issued an Order Instituting Disciplinary Proceedings (OIP) alleging violations of PCAOB rules and auditing standards by Melissa K. Koeppel, in auditing the consolidated financial statements of Koss Corporation (Koss) for the fiscal years ending June 30, 2006, 2007, and 2008. At all relevant times, Koss was an issuer, as defined by Section 2(a)(7) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(7), and PCAOB rules, and Koeppel was a person associated with a registered public accounting firm—Grant Thornton LLP—as defined by Section 2(a)(9) of the Act, 15 U.S.C. 7201(9), and PCAOB rules. Koeppel filed her Answer (Ans.) on September 27, 2011. After a nine-day hearing in June and October 2012, the hearing officer issued the initial decision on January 29, 2013. The Division petitioned for review of the decision, and Koeppel cross-petitioned for review. Briefing concluded on June 7, 2013. The Board heard oral argument on October 22, 2013.[1/]

[1/] Documents on the Index to the Record on Review are cited as Record Document (R.D.) __. We refer to the parties' post-hearing submissions as DPHS, DPHR, KPHS, KPHR; review petitions as DPet.,KPet.; and briefs to us as DOB, DRB, KOB, KRB.

III.

The OIP's charges against Koeppel, as the auditor with final responsibility for the 2006, 2007, and 2008 Koss audits, concern alleged "acts and omissions" in two main respects: (1) "failures to adequately examine Koss's journal entries for evidence of possible material misstatement due to fraud" and (2) "[failures] to audit adequately" certain financial statement assertions and a related account. The latter area consists of (a) the revenue-related matters of (i) Koss's financial statement assertions about the occurrence and valuation of net sales, Koss's largest income statement account, (ii) Koss's related, material "cooperative advertising and promotion allowances" account (as pertinent here, consisting of sales discounts and rebates), and (iii) Koss's financial statement assertions about the existence of accounts receivable, one of the two largest components of the current assets reported on Koss's balance sheet; and (b) Koss's financial statement assertions about the existence of inventory, the other of the two largest components of Koss's reported current assets. *E.g.,* R.D. 1, OIP at 1-4, 20-22 ¶¶ 1, 2, 6, 10, 73, 75, 80, 81.

In those aspects of each audit, in which the pertinent work of audit assistants was allegedly apparent to and accepted by Koeppel, the OIP charged that Koeppel violated PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, and Rule 3200T, *Interim Auditing Standards*, by:

- failing to exercise due professional care and skepticism, in violation of AU § 150, *Generally Accepted Auditing Standards*, and AU § 230, *Due Professional Care in the Performance of Work*;
- failing to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion, in violation of AU § 150 and AU § 326, *Evidential Matter*;
- failing to perform audit procedures to obtain reasonable assurance about whether the financial statements under audit were free of material misstatement caused by fraud, in violation of AU § 110, *Responsibilities and Functions of the Independent Auditor*, and AU § 316, *Consideration of Fraud in a Financial Statement Audit*;
- failing to adequately address the risk of management override of controls, in violation of AU § 316;
- failing to comply with AU § 319, *Consideration of Internal Control in a Financial Statement Audit*;
- failing to comply with AU § 329, *Analytical Procedures*;

- failing to comply with AU § 313, *Substantive Tests Prior to the Balance Sheet Date*; and

- failing to comply with Auditing Standard (AS) No. 3, *Audit Documentation*, to the extent that audit work bearing on the aforementioned charges was performed but not documented.

E.g., OIP 7-17, 19-22 ¶¶ 21, 27, 29, 30, 34, 37, 39-43, 45, 47-50, 52-54, 57, 59, 68, 69, 71, 72, 74, 75, 79-81. According to the OIP, Koeppel's alleged violations resulted from intentional or knowing conduct, including reckless conduct, or involved repeated instances of negligent conduct, each resulting in a violation of the applicable professional standards. *Id.* at 22-23 ¶¶ 82-83.

In summary, the alleged factual grounds for the charges before us are as follows.

Journal entries (*e.g.*, OIP 7-10 ¶¶ 20-28):

- In all three audits, despite a PCAOB inspection comment on the 2005 Koss audit and firm-wide Grant Thornton training in 2006 and 2007 calling attention to the need to select journal entries for fraud testing from a complete population, journal entries were not selected for audit testing from Koss's general ledger but from sets of paper records provided by members of Koss's accounting department from which entries could have been excluded.

Revenue-related accounts:

Net sales (*e.g.,* OIP 10-14 ¶¶ 30, 31, 34, 37-43):

- In all three audits, use was made, in testing Koss's net sales, of analytical procedures, which involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor, yet the procedures lacked sufficiently precise expectations to provide adequate support for the valuation and occurrence of net sales;

- In each of the three audits, reliance was placed on two particular net sales analytical procedures that used reports generated by Koss's information technology system without adequately supporting the completeness and accuracy of those reports, where the decision had been made not to test the operating effectiveness over the audit period of related Koss internal controls, *i.e.*, processes at Koss that individually or in combination were likely to prevent or detect material misstatements; and

- In the net sales analytical procedures in all three audits, there was a lack of documentation of sufficiently precise expectations and of evaluations of significant unexpected differences between expectations and recorded amounts.

Sales allowances (*e.g.*, OIP 10-12, 20-21 ¶¶ 30, 31, 34, 73-79):

- In all three audits, use was made, in testing Koss's sales discounts and rebates, of reports generated by Koss's information technology system without adequately supporting the completeness and accuracy of those reports, where the decision had been made not to test related Koss internal controls.

Accounts receivable (*e.g.*, OIP 10-12, 14-16 ¶¶ 30, 31, 34, 37, 44-49, 51-54):

- In all three audits, a report generated by Koss's information technology system was used to test Koss's accounts receivable as of a date two months before the balance sheet date, but the completeness of the report in establishing the population from which invoices would be selected for confirmation testing was not adequately supported, where related internal controls had not been tested;

- In the 2006 audit and the 2007 audit, reports generated by Koss's information technology system were used in an effort to extend audit conclusions based on the interim accounts receivable testing to the balance sheet date through a so-called rollforward procedure, but the completeness of the reports was not adequately supported, where related internal controls had not been tested; and

- In the 2008 audit, without explanation, no rollforward procedure was performed to assess the reasonableness of Koss's accounts receivable recorded during the remaining period between the interim date and the balance sheet date.

Inventory account (*e.g.*, OIP 10-12, 17, 19-20 ¶¶ 30, 31, 34, 37, 58-60, 67-71):

- In assessing the reasonableness of Koss's recorded inventory for the two-month remaining period after interim audit testing, use was made, in a rollforward procedure in all three audits, and in analytical procedures in the 2007 and 2008 audits, of reports generated by Koss's information technology system without adequately supporting the accuracy and/or completeness of those reports, where the decision had been made not to test related Koss internal controls.

IV.

Based on our review of the record, we find the facts in this case to be as follows:

A. Background On The Performance Of The Audits In Question

1. Koeppel Was the Auditor With Final Responsibility for the 2006, 2007, and 2008 Audits of Koss Corporation, a Family-Run Consumer Electronics Company.

Koeppel was the auditor with final responsibility, or engagement partner, for Grant Thornton's audits of the financial statements of Koss Corporation (Koss) for the fiscal years ending June 30, 2006, 2007, and 2008. R.D. 1 at 1-2 ¶ 2, 4 ¶ 10 (OIP); R.D. 22 at 2, 6 (Ans.); Tr. 738, 746, 753; *see generally, e.g.*, AU §§ 230.06, 311.02, 312.17, 316.74 (contemporaneous standards referring to auditor with final responsibility for the audit). The audits were to be conducted in accordance with PCAOB standards. Tr. 738 (Koeppel); Exs. J-65 at 1, J-173 at 1, J-276 at 1. Aside from certain audit procedures applied to Koss's journal entry processes, the audits did not test the operating effectiveness of Koss's internal controls for the audit period. Tr. 1254-57.

Koeppel began her accounting career with Arthur Andersen in 1986, became a partner at that firm in 1997, and, after that firm went of business in 2002, joined Grant Thornton as a partner in its Milwaukee office. Tr. 736-37. From 2002 to 2008, Koeppel was the Milwaukee office's audit practice leader, in charge of overseeing the practice, including providing audit training, and from April 2008 to April 2011, was the office's managing partner. Tr. 738-40, 795, 1203-08.

Grant Thornton began auditing Koss in 2004 and also conducted reviews of Koss's quarterly financial information. Tr. 271-72; Exs. J-65 at 2-3, J-173 at 2-3, J-276 at 2-3. Koeppel, who participated in the firm's successful bid for the engagement, also led the 2004 and 2005 Koss audits, though only the 2006 to 2008 audits are in question here. R.D. 1 at 4 ¶ 10; R.D. 22 at 6; Tr. 271-72, 738. Koss was one of Koeppel's first two public company audit clients at the firm, having brought none over from Andersen. Tr. 737-38. Koeppel testified that, at Grant Thornton, she typically would lead audits of three to five public companies in a given year and that Koss was a "midsized" or "middle market" company in terms of size and "most akin, probably, to my private [company] clients, where they had large family ownership," "weren't terribly complex operations," and "did not put huge dollar sums into [their information technology] systems." Tr. 1178-79, 1221-22, 1301, 1342, 1375, 1484-86 (Koss management "preferred to put their dollars to" product research and development "rather than internal systems"), 1502 ("this isn't a big company at about 50 million of sales" and its "management team had been around for many years"). Certain limitations or deficiencies in Koss's internal systems and processes impacted the audit work in ways that will be discussed later.

Working directly under Koeppel on the Koss audits, and assisting her in part with supervision of the work, was the same individual (Audit Manager), who acted as audit manager and held the title of manager or senior manager during 2006 to 2008. Tr. 746, 1163-64 (Koeppel). Koeppel testified that Audit Manager, who had also joined Grant Thornton from Arthur Andersen, had “significant experience” auditing public companies and specialized in audits of consumer industrial product companies. *Id*. The Koss audit teams also included several junior auditors, three of whom testified at the hearing: (1) a member of the 2006, 2007, and 2008 audit teams who was assigned to the engagement about eight months after joining Grant Thornton from college (2006-2008 Staff/In-Charge Auditor); (2) a member of the 2007 and 2008 teams who was assigned to the engagement about seven months after joining the firm from college (2007-2008 Staff/In-Charge Auditor); and (3) a member of the 2007 and 2008 teams who was assigned to the engagement as his first public company audit after about four months as an intern at the firm and about a month after receiving a master’s degree in accountancy (2007-2008 Staff Auditor). Tr. 374, 375, 421, 442, 446-47, 529, 563, 638, 753.

For the 2006, 2007, and 2008 Koss audits, the auditors performed some of the field work in the accounts receivable and inventory areas as of an interim date of April 30 and the audit work in the net sales and special sales allowance areas as of June 30. Overall, the auditors generally did two days of planning in March or April, were usually in the field two days a week in late April or early May for the interim work and to largely document Koss’s internal controls over financial reporting, and were back in the field the second or third week of July, often followed by another day or two in the field for follow-up and concluding procedures. *E.g.*, Tr. 270-71 (2006-2008 Staff/In-Charge Auditor); Ex. R-509 at 13-16 (Audit Manager); *see* Ex. J-239 at 5 (audit firm’s timeline of 2008 Koss audit); Exs. R-202 at 7, 8, R-295 at 4, 5, 6, R-393 at 4, 6 (planned schedules).

Koss designed, manufactured, and sold stereo headphones and related accessories. The company’s headquarters and main plant were located in Milwaukee, Wisconsin, and Koss employed between 115 people in 2006 and 76 in 2008. It sold its products in the United States through domestic sales representatives, dealers, and retail outlets and internationally through domestic sales representatives and a sales office in Switzerland that utilized independent distributors in several foreign countries. R.D. 1 at 5 ¶ 14; R.D. 22 at 8; Exs. J-59 at 5-7, 38, J-172 at 6-8, 39, J-268 at 4-6, 37; Exs. J-54 at 2, J-153 at 3, J-250 at 5 (inventory audit programs for 2006, 2007, and 2008 Koss audits, stating that there “is one physical location for Koss”); Tr. 1411-12.

During the relevant period, the family for which the company was named owned approximately 75% of its stock. Tr. 1220. One family member, Koss’s founder, served as Koss’s chairman of the board; one of his sons was vice chairman, president, chief executive officer, chief operating officer, and chief financial officer (President/CEO); and another son was vice president for sales (VP-Sales). Exs. J-59 at 41, J-172 at 42, J-268 at 12, 39; Tr. 93, 145, 154, 1220. Koss’s accounting department, which did not include any members of the family, was led by a vice president of finance and principal accounting officer (VP-Finance), who was in charge of Koss's accounting and financial reporting function and, unlike President/CEO and other members of the department, was an accountant. The department was otherwise staffed by Senior Accountant and Junior Accountant, who reported directly to VP-Finance. *E.g.*, R.D. 1 at 2 ¶ 4; R.D. 22 at 3; Tr. 1478 (Koeppel); Tr. 46-48 (2006-2008 Staff/In-Charge Auditor); Tr. 548 (2007-2008 Staff Auditor); Ex. R-509 at 55 (Audit Manager's investigative testimony); Exs. J-6 at 1-2, J-103 at 1-2, J-203 at 1-2; Ex. J-7 (2006 audit work paper); Ex. J-304 at 5, 7, 29, 68 (Koss disclosure). These executives and accounting department members all worked at Koss's Milwaukee headquarters office, where the company accounted for all operations and financial reporting. Exs. R-202 at 3, R-295 at 3, R-393 at 3.

Koss reported to the public that it prepared its financial statements in accordance with Generally Accepted Accounting Principles (GAAP). Exs. J-59 at 20, J-172 at 21, J-268 at 19. The company generally recognized revenue from sales upon shipment of the product to the buyer, rather than when payment was received. Koss offered sales incentives to certain of its customers, including rebates and discounts, primarily by issuing credit memoranda that the customers applied to their outstanding invoices from Koss, rather than by making cash payments. When recognizing revenue, Koss recorded the estimated cost of these sales allowances as a reduction to sales, reporting net sales on its income statement. At the end of fiscal years 2006, 2007, and 2008, the total amount of discounts and rebates that, according to Koss, had been earned by customers and recorded in its income statement but had not yet been settled through either a payment to the customer or a credit to Koss's accounts receivable were reported in a financial statement note as the "cooperative advertising and promotion allowances" component of the accrued liabilities line item on Koss's balance sheet. Tr. 154, 1118-21; Exs. J-59 at 19, 30, J-172 at 19, 31, J-268 at 17, 29; Exs. J-6 at 7, J-103 at 6; Exs. J-43 at 2, J-136 at 2, J-229 at 2; Exs. J-41, J-133, J-226; R.D. 1 at 20 ¶ 73; R.D. 22 at 30-31. Also, Koss reported on its balance sheet a figure for the value of its fiscal year-end inventory, which consisted of raw materials and finished goods. Exs. J-59 at 27, 31, J-172 at 28, 32, J-268 at 26, 30.

Specifically, for fiscal years 2006, 2007, and 2008, respectively, Koss reported: (1) annual net sales of about $50.9 million, $46.2 million, and $46.9 million, which was by far the largest line item on its income statement each year; (2) year-end unsettled discounts or rebates of some $1.2 million, $1.3 million, and $740,000, representing by far the largest component, at between 41% and 58%, of Koss's reported accrued liabilities and between 13% and 32% of Koss's reported total current liabilities at year end; (3) year-end accounts receivable, net of allowance for doubtful accounts, of more than $6.8 million, $7.9 million, and $10.1 million, representing between 22% and 34% of Koss's reported year-end total current assets; and (4) year-end inventories of about $10.5 million, $9.9 million, and $9.4 million, representing between 31% and 37% of Koss's reported total year-end current assets. Exs. J-59 at 26, 27, 36, J-172 at 27, 28, 31, 38, J-268 at 25, 26, 36. It is undisputed that each of these amounts was material to

Koss's respective financial statements. OIP 12, 14, 17, 20 ¶¶ 38, 44, 58, 74; Ans. 19, 21, 25, 30-31 ¶¶ 38, 44, 58, 74; Tr. 153-54, 875-76, 1018-20, 1086-87, 1121.

Koeppel, on behalf of Grant Thornton, authorized the issuance of audit reports expressing unqualified opinions on Koss's financial statements for fiscal years 2006, 2007, and 2008. R.D. 1 at 2 ¶ 3, 4 ¶ 10; R.D. 22 at 2, 6; Tr. 741, 745-46. Each audit report bore a date in the latter half of August and was included in Koss's Form 10-K, filed a few days to a week later with the Securities and Exchange Commission (Commission or SEC). Exs. J-59 at 25, J-172 at 26, J-268 at 24. Koss's stock was publicly traded on the NASDAQ Stock Market. R.D. 1 at 5 ¶ 14; R.D. 22 at 8; Exs. J-59 at 3, 13, J-172 at 4, 14, J-268 at 3, 12.

On December 24, 2009, and January 4, 2010, Koss filed Forms 8-K with the SEC stating, in part, that Koss's previously issued financial statements included in Form 10-Ks for its fiscal years ending June 30, 2005, 2006, 2007, 2008, and 2009 should no longer be relied upon "because of the discovery of unauthorized financial transactions" that were subject to an ongoing "internal investigation under the supervision of an independent committee of the Board of Directors with the assistance of independent counsel and forensic accountants." Ex. J-305 at 2, 3; Ex. J-304 at 5. On June 30, 2010, Koss filed a Form 10-K/A with the SEC restating its 2008 and 2009 financial statements. A restatement corrects an error in previously issued financial statements that is due to facts that existed at the time they were prepared. *See* Accounting Principles Board Opinion No. 20 ¶ 13, *Accounting Changes*; Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, ¶¶ 2.h & j.

According to Koss's Form 10-K/A, the restatement was required principally to reflect adjustments related to fraudulent unauthorized transactions made by the three above-described members of Koss's accounting department, in collusion with each other. Ex. J-304 at 5, 7, 29-30, 41, 48-50, 52, 68. Koss noted that VP-Finance had been indicted in connection with the misappropriations. *Id.* at 5. Koeppel testified in the present case that the plea agreement resolving those criminal charges stated that VP-Finance began committing fraud at Koss in 1997. Tr. 1216. Koss's filing stated that the wrongful transactions from fiscal year 2005 through December 2009 totaled some $31.5 million. Ex. J-304 at 5. Of that amount, about $2.3 million, $3.5 million, and $5.1 million, respectively, were determined to have been misappropriated from the company in fiscal years 2006, 2007, and 2008, when Koss had originally reported net income of about $6.2 million, $5.2 million, and $4.5 million, respectively. *Id.* at 6; Ex. J-268 at 25.

Koss's Form 10-K/A stated that the misappropriation was carried out largely through unauthorized transactions involving wire transfers and cashier's checks to pay VP-Finance's personal expenses, in circumvention of Koss's internal controls and other operating procedures. Koss explained that to hide the true nature of the transactions, the persons involved had manipulated its internal controls and procedures relating to its computer system for processing financial transactions; recorded numerous false journal entries in various accounts, understating net sales and overstating assorted costs of goods sold and administrative expenses; delayed posting cash received against outstanding invoices and failed to provide an allowance for certain doubtful accounts, overstating accounts receivable; and failed to properly perform and review on a regular basis and at the end of reporting periods key account reconciliations, including cash, which was overstated. Ex. J-304 at 5, 7, 29-30, 41, 48-50, 52.

2. In Planning the Audits, Koeppel Recognized the Need To Address the Risk of Management Override of Internal Controls Through Testing Koss's Journal Entries, and She Viewed the Revenue and Inventory Areas as Posing the Greatest Risk of Material Misstatement, and as Requiring the Heaviest Focus and Most Rigorous Audit Procedures, of Any of the Audit Areas.

Koeppel led the planning of the 2006, 2007, and 2008 Koss audits. *E.g.*, Tr. 747, 1237 (Koeppel: "very involved" in planning); KPHS 5 ("directly participated in planning the audits"). This included making materiality determinations; seeking to obtain an understanding of the financial reporting process and internal controls in place at Koss; assessing audit risk; considering the particular risk that Koss's accounting records might be manipulated through inappropriate or unauthorized journal entries; and identifying, in its business processes and financial statements, what the auditors called "significant transaction cycles with critical assertions," all for consideration in determining the nature, timing, and extent of the audit procedures. *E.g.*, Exs. R-202 at 2-7, R-295 at 2-5, R-393 at 2-5 ("Developing the Audit Plan" work papers for 2006, 2007, and 2008 Koss audits); Tr. 839-40 (Koeppel); *see generally, e.g.,* AU §§ 311.03, 312.01., 16, .19, 316.02, .58 & n.23, 319.05, .81. Koeppel approved the audit programs that set forth the procedures believed to be necessary to accomplish the audit objectives. *See, e.g.*, Tr. 774-79, 1237-40, 1242-45, 1248-54, 1437 (Koeppel); Ex. D-4 at 120 (Audit Manager testified in investigation that she and Koeppel "worked together in designing and outlining the [revenue] audit plan and the approvals of the tailoring and the procedures that were outlined"); Exs. R-202 at 9, R-295 at 6, R-393 at 6 (statement, initialed by Koeppel, in work papers for 2006, 2007, and 2008 audits that "[a]s engagement partner, I approve the audit plan, including the audit approach"); *see generally* AU § 311.09.

Koeppel testified that she applied a Grant Thornton methodology to develop the strategies and organize the work in the Koss audits in question. *E.g.*, Tr. 867, 870-71. In each of the audits, she grouped together various related income statement and expense accounts and balance sheet accounts—for example, revenue-related financial statement elements including sales, accounts receivable, allowances, and cash receipts or inventory-related elements including inventory, accounts payable, and cost of goods sold—into a "transaction cycle" to "reflect normal business processes, double entry bookkeeping, and the functioning of accounting and control systems" and "permit us to account for the interrelationships among audit procedures and assertions for income and expense accounts and corresponding elements on the balance sheet." Exs. J-60 at

12, 13, 23, J-139 at 15, 16, 27, J-269 at 10, 11, 22-23 (Grant Thornton audit manuals for relevant period). The approach focused audit attention on "significant transaction cycles with critical assertions," also referred to as "critical cycles," "where there is a risk of material misstatement." Exs. J-60 at 13, J-139 at 16, 17, J-269 at 11, 12; Exs. R-202 at 3, 6, R-295 at 3, 4, R-393 at 3, 4 (planning documents for 2006-2008 audits).

Identification of a cycle as critical resulted in additional attention and focus on that area in the Koss audits. *See, e.g.,* KPHS 58; Tr. 115 (2006-2008 Staff/In-Charge Auditor: designation as critical "increased the work and the scope performed there"); Ex. J-200 at 4 (2008 audit work paper). According to Koeppel, a "critical assertion" was a financial statement assertion that had a reasonable possibility of material misstatement. Tr. 843-44; *see* Exs. J-60 at 13, J-139 at 16, 17, J-269 at 11, 12 (firm audit manuals, explaining that audit procedures "are focused on assertions" referred to as "critical to the audit," "where material misstatements are more likely to exist").[2/]

In each Koss audit, Koeppel concluded that 11 transaction cycles should be identified, that two should be designated as critical, and that, within those two cycles, a total of three assertions pertinent here should be deemed critical. Specifically, Koeppel considered "Revenue" to be a critical transaction cycle at Koss and "Existence/Occurrence" and "Valuation - Net" to be the critical assertions within that cycle. And Koeppel considered "Inventory – Purchasing (US Manufacturing)" to be Koss's other critical transaction cycle, with "Existence/Occurrence" a critical assertion within it. *E.g.*, Tr. 845-47, 874; *see* Exs. J-15 at 1, 3, J-109 at 1, 3, J-209 at 1, 3 & Exs. J-13, J-107, J-207 (2006-2008 audit planning work papers); Ex. J-49 at 1, 4 (2006 work paper); *see also* Exs. J-60 at 12, 17, J-139 at 15, 20-21, J-269 at 10, 15-16 (2006-2008 audit manuals); *see generally* AU §§ 326.04 ("Assertions about existence or occurrence address whether assets or liabilities of an entity exist at a given date and whether recorded transactions have occurred during a given period."), .07 ("Assertions about valuation or allocation address whether asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts."). As summarized by a 2008 Koss audit planning work paper that Koeppel reviewed, "revenue and inventory have been deemed critical which will allow us to focus heavily on those areas during the audit." Ex. J-200 at 4, 7; *see* Tr. 1751-52 (Koeppel).

[2/] *See generally, e.g.,* AU §§ 326.03 ("Assertions are representations by management that are embodied in financial statement components."), .13, .25; Auditing Standard (AS) No. 2 ¶ 70 (applicable to 2006, 2007 Koss audits, defining "relevant assertions" as "assertions that have a meaningful bearing on whether the account is fairly stated"); AS No. 5, Appendix A9 (applicable to 2008 Koss audit, defining "relevant assertion" as "a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated").

For each audit in question, the audit program Koeppel approved for revenue included substantive procedures for testing net sales and accounts receivable. *See* Exs. J-16, J-110, J-210; Tr. 874. She testified that she considered sales allowances, as well as net sales and accounts receivable, to be part of the revenue cycle and that she relied, in part, on the audit testing of those allowances to form conclusions concerning the validity of Koss's assertion that it reported sales at their net realizable value. Tr. 845-46, 874, 1082, 1119, 1127; *see* OIP 20 ¶ 74; Ans. 31 ¶ 74; Exs. R-300 at 15 & R-398 at 15 (2007 and 2008 Koss audit planning documents identifying "Credits, sales allowances" as a transaction within the "Revenues" cycle); Ex. R-509 at 151 (Audit Manager's investigative testimony). And each year the audit program Koeppel approved for inventory included substantive procedures for testing inventory and related accounts such as cost of goods sold. *See* Exs. J-54, J-153, J-250; Tr. 1391-92.

Grant Thornton's audit methodology "emphasized" a general type of substantive procedure—either "Test of Details" or "Analytical"—for the balance sheet side of a critical cycle and for the income statement side. *E.g.*, Exs. J-60 at 21, J-139 at 25, J-269 at 20 (audit manuals); *see generally* AU § 319.108 ("The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures."); AU § 329.05 (analytical procedures "involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor" by "identifying and using plausible relationships that are reasonably expected to exist"). The type of procedure emphasized for the balance sheet elements and for the income statement elements depended upon how the auditor assessed both inherent risk and control risk. According to the firm's audit manuals, "to determine the type and extent of audit procedures to perform that will reduce the risk of material misstatement to a low level," "we apply" a methodology, "[f]or all critical assertions," that "matches the nature, timing, and extent of substantive audit procedures to our assessment of two components of audit risk – inherent risk and control risk." The approach "combines the inherent and control risk assessments" in a chart called "the ABC Audit Strategy Matrix," which "moves from heavy emphasis on tests of details in situations of high risk to minimizing tests of details, where possible, in situations of low risk" and calls for substantive procedures that "may be grouped into three separate strategies"—either A, B, or C. Exs. J-60 at 12, 13, 19, 20, 22, J-139 at 15, 17, 23, 24, 26, J-269 at 10, 11, 18, 19, 21, 22-23; Ex. R-483 at 2 (June 2, 2006 firm bulletin); *see* Tr. 850 (Koeppel).

In planning each audit, Koeppel concluded that the inherent risk of misstatement for each critical assertion was low. Tr. 1249-50; Exs. J-13 at 1, J-107 at 1-2, J-207 at 1-2; see Exs. R-509 at 73 & D-4 at 73 (Audit Manager's investigative testimony). This assessment was based in part on evaluation of a list of general inherent risk indicators, categorized as economic, industry, external, management, fraud, governance, operating, or financial. She deemed most of these indicators "not applicable" to Koss, including "Unskilled or inexperienced accounting personnel," "Ineffective accounting or information systems," and "Difficult to audit transactions or balances." Tr. 1243; J-70, J-178, J-278; *see generally* AU § 319.47 ("The information system relevant to financial reporting objectives, which includes the accounting system, consists of procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.").

The inherent risk assessment was also based on consideration of the potential that the financial statements were materially misstated due to a half-dozen risks at the financial statement level, each of which Koeppel regarded as "Low" for Koss, including "Errors in the accounting system," "Fraudulent financial reporting," "Misappropriation of assets," and "Errors in accounting for non-routine transactions." Tr. 1245-47; Exs. J-72, J-180, J-275. Additionally, Koeppel considered a list of inherent risk indicators at the level of each critical assertion, viewing no more than a few of these indicators in any given year as "applicable" and the rest, including "Potential for fraudulent financial reporting," and, as to revenue, "Potential for misappropriation of assets," as "not (rarely) applicable." Tr. 1243-44; Exs. J-71, J-179, J-279.

It was further noted by Koeppel in audit planning that "[d]ue to the small size of the organization, there is a risk that the lack of segregation of duties may cause rise to fraudulent financial reporting." Exs. J-100 at 1, 3, 6, J-200 at 1, 3, 7 (2007 and 2008 memoranda documenting audit planning meeting led by Koeppel); *accord* Ex. J-3 at 1, 3 (2006 memorandum); OIP 6-7 ¶¶ 20, Ans. 10 ¶ 20; Tr. 779-80, 810, 829-32 (Koeppel); Tr. 708-09 (2007-2008 Staff Auditor). To Koeppel, segregation of duties meant that no one person was responsible for the authorization, recordkeeping, and custody of transactions, and she testified it was "very important" that a "senior official should not have access to both create, post and approve journal entries" and that she "would want to take careful note of" circumstances that "could've resulted in a lack of segregation of duties." Tr. 1301-03, 1307-08, 1473-74; *see* Ex. J-2 at 15-16 (Grant Thornton IT specialists commented in a 2004 "IT Review" of Koss, on which Koeppel relied in the 2006-2008 audits, that "[s]egregation of duties is a primary consideration and requires multiple individuals to be involved in all material transactions, including granting access rights to material processes"); pp. 23-26 below. As Audit Manager explained in the investigation, "Ideally, you want an environment where you've got custody, authorization and record keeping being separate. You can typically have some overlap of one or two of them, but you certainly don't want any one person who can…have full custody, authorization and record keeping of all aspects…one person doing everything from start to finish through a process without any other supervision or monitoring in place." Exs. R-509 at 37-39 ("appropriate checks and balances in place" rather than "incompatible roles, that someone may be wearing multiple hats") & D-4 at 68-69.[3/]

[3/] *See generally* AU § 319.20 (a breakdown in segregation of duties "could result in unauthorized transactions or changes to programs or data that could affect the financial statements"); O'Reilly, Vincent M., *et al.*, Montgomery's Auditing (12th ed. 1998), p. 11-10 ("If internal control is to be effective, there needs to be an adequate division of responsibilities among those who perform accounting procedures or control activities

With regard to control risk, it was stated in audit planning that "primarily due to the lack of segregation of duties, GT did not conclude" that "a number of controls in place to mitigate the risk of loss and/or fraud" at Koss "brought control risk to a LOW level," and "[a]s such, GT has not placed reliance on those controls, nor did we perform any testing of said controls." Exs. J-3 at 1, 3, 4, J-100 at 1, 3, 4, 6; *see* Ex. J-200 at 1, 3, 4, 7; Tr. 779-84, 808-13, 1146, 1302-03 (Koeppel). In addition, Koss was exempt during the relevant period from the internal controls testing requirement in Sarbanes-Oxley Act Section 404, and engaged Grant Thornton to perform a financial statement audit, not an integrated audit of both financial statements and internal control over financial reporting. *See, e.g.*, Ex. J-268 at 21; Exs. J-65 at 1, J-173 at 1, J-276 at 1. Koeppel testified she took that into consideration, as well as reasons of efficiency based on the timing of the Koss audits and her view that controls were not necessarily documented at a company of its size, in deciding that, aside from certain audit procedures applied to journal entry processes, the audits would not test the operating effectiveness of Koss's internal controls for the audit period. Tr. 1254-57.

Instead of testing Koss's internal controls over critical cycles and assertions, the auditors would seek to obtain an understanding of those controls sufficient to plan the audits by performing procedures to understand the design of relevant controls and determine whether they had been placed in operation; would assess control risk by setting it at the maximum level; and would seek to restrict detection risk to an acceptable level by performing only substantive tests, not tests of internal controls.[4/]

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and those who handle assets. This segregation of duties consists of assigning different people to authorize a particular class of transactions, perform control activities when the transactions are processed, monitor those activities, maintain the related accounting records, and handle the related assets. Such arrangements reduce the risk of error and limit opportunities to misappropriate assets or conceal other intentional misrepresentations in the financial statements [and]…serve[] as a deterrent to fraud or concealment of error because of the need to recruit another individual's cooperation (collusion) to conceal it.").

[4/] *E.g.,* Tr. 784, 851-60, 918, 1025, 1253-56, 1287, 1307-10, 1345, 1468 (Koeppel); *see* Tr. 114, 116-17, 262, 270, 314 (2006-2008 Staff/In-Charge Auditor); Tr. 689-90 (2007-2008 Staff Auditor); Exs. D-4 at 32-33, 35, 54, 60, 73-74 & R-509 at 156 (Audit Manager's investigative testimony); Exs. J-132 at 2 (2007 audit "includes consideration of internal control over financial reporting" as "a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control or to identify deficiencies in internal control"), J-39 at 2 (similar for 2006 audit); Ex. R-483 at 4 (June 2, 2006 Grant Thornton bulletin to its auditors: "If controls are not tested or if controls are tested and not operating effectively, control risk must be assessed as High for the assertion."); Exs. J-3

Where, as here, inherent risk was assessed as low and control risk was assessed as high for the critical assertions, the Grant Thornton methodology applied by Koeppel in the Koss audits at issue called for a "combined medium risk" strategy named the "'B' Approach." *E.g.*, Ex. R-483 at 7-8; Exs. J-15, J-109, J-209 (work papers identifying the letter of the strategy used for assertions within each of the applicable critical and non-critical cycles). Grant Thornton proprietary software used in those audits generated audit programs populated with firm-suggested procedures consistent with that approach and audit planning information entered by the auditors. Tr. 754-55, 1176-77, 1180, 1238-39 (Koeppel); Tr. 274, 314-15 (2006-2008 Staff/In-Charge Auditor). Koeppel described these work programs as "the starting point of the work that you needed to perform." Tr. 1177. Koeppel recognized that it was she who was ultimately responsible that the Koss audits be conducted in accordance with PCAOB standards. *See, e.g.*, Tr. 1438.

The firm's audit manuals explained that the "B" strategy "requires analytical procedures to be augmented with tests of details" and "emphasizes analytical procedures on income statement accounts and tests of details for balance sheet accounts." Exs. J-60 at 20, 21, J-139 at 24, 25, J-269 at 19, 20; *see* Tr. 870-75, 1263 (Koeppel); Tr. 318-20 (2006-2008 Staff/In-Charge Auditor); *compare, e.g*., Ex. J-60 at 21 ("A" strategy emphasized analytical procedures for both categories of accounts and "C" strategy emphasized tests of details for both). For example, the revenue audit programs for the 2006, 2007, and 2008 Koss audits included analytical procedures on sales. *See, e.g.*, Tr. 1435; Ex. J-16 at 2, 4.

The manuals further noted that the "B" strategy "only represent[s] a starting point in tailoring substantive audit procedures" and that, "[i]n response to identified risks, the auditor may decide to substitute a more detailed procedure than the procedure suggested by the strategy." Exs. J-60 at 22, J-139 at 26, J-269 at 21; *see* Tr. 1439 (Koeppel). Koeppel claimed at the hearing, however, that "as it relates specifically to Koss, there were not a lot of unusual items or things that weren't already incorporated into the [firm's software-produced] work programs. So we did not have to do a lot of tailoring." Tr. 1176-77; *accord, e.g.,* Tr. 1263-64, 1430, 1494, 1498 (Koeppel); Ex. R-509 at 61, 64-65, 106, 163 (Audit Manager's investigative testimony). But there is no evidence that the audit programs, as produced by the firm's software, specifically reflected certain Koss system limitations and internal control information, discussed below (*see* pp. 18-21, 24-29), that mattered to the audits. Nor was the "'B' approach" of those audit programs, which equally applied to a low-inherent-risk-high-control-risk audit

at 4 (2006: auditors assessed control risk "for critical cycles…at High," having not "perform[ed] any testing of said controls"), J-100 at 4 (same, 2007); Exs. J-12, J-106, J-206 (2006-2008 concluding procedures work paper: "no" tests of controls, "not performed"); Exs. J-13, J-107, J-207 & Ex. R-202 at 7 (2006-2008 work papers: "High" control risk); *see generally, e.g.,* AU § 312.30; AU §§ 319.02, .04, .25, .27, .65, .66.

and a high-inherent-risk-low-control-risk-audit, tailored to specific issues of reliability of client system-generated data posed by the former type of audit. *See, e.g.*, Tr. 1439-44.

For non-critical assertions that nevertheless "may contain material monetary amounts," the firm's manuals identified a "D Strategy," which consists of "less extensive substantive audit procedures" and "concentrates on techniques such as inquiry and analytical procedures to identify items that warrant detailed examination." The firm manuals also noted that "we will often identify transaction cycles or assertions where no procedures will be necessary." Ex. J-60 at 21, 22; *see* Exs. J-139 at 24-25, 27, J-269 at 20, 22. All of the foregoing aspects of the firm's methodology were applied by Koeppel in planning the 2006, 2007, and 2008 Koss audits. *See, e.g.*, Tr. 1258-63 (Koeppel); Exs. J-15 at 1, 3, J-109 at 1, 3, J-209 at 1, 3 (2006-2008 audit work papers).

3. Koeppel Noted Particular Areas of Greater Risk That Needed To Be Addressed in Each Year's Audit Work on Koss's Journal Entries and the Revenue and Inventory Areas.

Although in leading the planning of the 2006, 2007, and 2008 Koss audits, Koeppel concluded that the overall inherent risk of material misstatement was low, she also concluded that there were particular areas of relatively greater risk to which the audits needed to respond. *E.g.*, Tr. 1273-74.

Koeppel testified that for each of the audits in question she participated in what PCAOB standards describe as "[a]n exchange of ideas or 'brainstorming' among the audit team members…about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated" (*see* AU § 316.14). Tr. 778-79, 808-09; Exs. J-3 at 1, J-100 at 1, J-200 at 1 (work paper in each audit memorializing the meeting). These fraud brainstorming sessions took note of the circumstance described in PCAOB auditing standards that "[m]aterial misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (a) recording inappropriate or unauthorized journal entries throughout the period or at period end, or (b) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications" (AU § 316.58). *E.g.*, Exs. J-3 at 4, J-100 at 4.

Relatedly, in each audit, Koeppel deemed it to be an applicable indicator of inherent risk at Koss and an "[a]rea[] where management override of controls may impact risk assessment" that "operating and financial decisions are dominated by a few individuals," and she believed that this risk factor could potentially result in a material misstatement and that the auditors needed to remain cognizant of it throughout the audit. *E.g.*, Exs. J-70 at 2, J-178 at 2, J-278 at 2; Ex. J-200 at 1, 2, 3, 4; *see* Tr. 300-02 (Staff/In-Charge Auditor); Ex. R-509 at 62, 67 (Audit Manager's investigative testimony).

Furthermore, it was noted in the fraud brainstorming sessions that "[d]ue to the small size of the organization, there is a risk that the lack of segregation of duties may cause rise to fraudulent financial reporting." Exs. J-100 at 3, J-200 at 3; *see* Ex. J-3 at 3; Tr. 830-32. The specific audit response approved by Koeppel to this identified risk was to "closely review unusual journal entries and perform journal entry control testing." Exs. J-3 at 1, 3, J-100 at 3, 6, J-200 at 3, 7; Tr. 778-81, 810, 829, 832 (Koeppel); OIP 6-7 ¶¶ 20, 22, Ans. 10-11 ¶¶ 20, 22; *see* Tr. 536-37 (2007-2008 Staff/In-Charge Auditor).

Koeppel approved an overall audit response to the risk of management override of controls that was summarized in the brainstorming sessions as follows: "understanding and considering any controls (or lack thereof) the entity has in place to address the identified fraud risk factors," which consideration "would need to include an added sensitivity to management's ability to override such controls" (Exs. J-3 at 1, 3 (2006), J-100 at 3, 6 (2007); Tr. 779); and understanding "through inquiries with staff and upper management, observations and walkthroughs as to the possibility of management override," assessing revenue and inventory as "critical which will allow us to focus heavily on those areas during the audit," and "test[ing] journal entry controls each quarter and at year-end, as well as review[ing] for unusual journal entries" (Ex. J-200 at 4, 7 (2008); *see* Ex. J-100 at 4, 6 ("GT will substantively test journal entries throughout the period and thoroughly review journal entries posted around year-end")).

More generally, the brainstorming sessions for the 2006, 2007, and 2008 Koss audits noted that the audits needed to respond to the risk of material misstatement due to fraud relating to revenue recognition. *E.g.*, Tr. 764-65, 1020-21, 1285-86; Exs. J-3 at 3, J-100 at 3, J-200 at 3, 4. The susceptibility of inventory to misappropriation was also identified in the sessions as a fraud risk. Exs. J-3 at 3, J-100 at 3, J-200 at 3; Tr. 1087 (Koeppel); see Ex. J-279 at 3.

Among other inherent risk indicators Koeppel deemed applicable in audit planning were "[h]eavy concentration of personal wealth in the business," "[i]neffective or absence of internal audit function," "[h]igh degree of competition, accompanied by declining margins," and "[p]ressure to meet expectations of analysts, creditors, and others." Exs. J-70 at 1, 2, 3, 4, J-178 at 1, 2, 3, 4, J-278 at 1, 2, 3, 4; Exs. J-3 at 2, 3, J-100 at 2, 3, J-200 at 1, 2, 3, 4; *see* Exs. R-205 at 4, R-299 at 4, R-396 at 3 ("The Company does not have an internal audit function due to the size of the organization."); *see generally* AU § 319.24 (noting that "when the nature of management incentives increases the risk of material misstatement of financial statements, the effectiveness of control activities may be reduced" and that an effective internal audit function "may constrain improper conduct by management").

4. In Each Audit in Question, the Audit Procedures Needed To Reflect Koeppel's Assessment of Maximum Control Risk and Identification of Control Deficiencies.

As noted, in planning the audits in question, Koeppel chose not to test the operating effectiveness of Koss's internal controls over financial reporting, including its financial statement assertions of existence/occurrence and net valuation of its revenue and existence of its inventory. She thus did not rely on internal control testing to reduce the substantive audit procedures required in those areas, and she set control risk at the maximum. Tr. 859, 1253, 1257-58, 1287; *see* Exs. D-4 at 35, 73, 74 & R-509 at 56, 73 (Audit Manager's investigative testimony). It was stated in Koss audit planning sessions led by Koeppel that assessment of control risk at that level "will impact necessary substantive testing to be performed through larger sample sizes or additional testing in critical areas including revenue recognition and inventory reporting." Exs. J-3 at 4, J-100 at 4. Koeppel testified that this lack of internal controls testing also meant that the auditors needed to obtain other audit evidence and perform additional audit procedures to support the reliability of data used in performing the substantive audit testing that was generated from Koss's information technology (IT) system. Tr. 847, 1025, 1142, 1443.

Additionally, Koeppel noted certain deficiencies in Koss's internal controls during the relevant audit periods, which at least had the effect of depriving the auditors of certain information relevant to the validity of Koss's journal entries and critical assertions and of placing greater weight on the other audit evidence obtained. Koeppel testified that if internal control issues were identified in the audits, "we do consider it to be part of our professional responsibility" to "bring those to the attention of management" and also "have a responsibility to assess how [each issue] impacts our audit plan and whether or not we need to modify our audit plan." Tr. 1179-80. In communicating these matters to Koss's board of directors, and in at least some cases just to its audit committee, prior to issuance of the audit reports each year, Grant Thornton, through Koeppel, explained that: (1) a "control deficiency" exists "when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis"; and (2) a "significant deficiency" is "a control deficiency, or combination of control deficiencies, that adversely affects a company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted auditing principles such that there is more than a remote likelihood that a misstatement of the entity's annual or interim financial statements that is more than inconsequential will not be prevented or detected." Exs. J-39 at 2, J-132 at 2 (August 30, 2006 and August 15, 2007 letters to Koss signed in firm's name by Koeppel); Tr. 1122-26, 1180 (Koeppel); *see* Ex. J-239 at 7, 9 (July 16, 2008 presentation to Koss's audit committee); *see generally* AU § 325.

Specifically, one of these matters concerned Koss's program of offering its discounts and rebates to its customers on the basis of informal, unwritten agreements. *See, e.g.,* OIP 20 ¶ 75; Ans. 31 ¶ 75; Ex. J-227 at 1. In 2006 and 2007, Koeppel advised Koss that the lack of "formalized contracts that document the terms of such agreements" was a control deficiency and that signed agreements would "allow for the proper documentation to be retained by the Company, and act as support so that these discounts are stated and accrued for correctly." Exs. J-39 at 4, J-132 at 3 (August 2006, 2007 letters to Koss); *see* Exs. R-202 at 2, J-37 (2006 audit planning work papers noting issue), R-295 at 2 (same, 2007). In 2008, she elevated the matter to a significant control deficiency, conveying to Koss's audit committee the "[p]otential impact" of the issue as follows: "By not having formal agreements in place, the Company does not have proper documentation to support the discounts given and the related accrual" (Ex. J-239 at 7). Tr. 1121-27, 1195, 1401-03 (Koeppel sought to "highlight that it is an area of concern and potential risk in their financial reporting process"); *see* Ex. R-393 at 2, Ex. J-227 at 1, Ex. R-482 at 723 (2008 work papers noting issue); Tr. 474-79. A 2008 work paper explained, "When considering the severity of this issue, GT has assessed this finding as a significant deficiency and has therefore included it in the internal control letter. Note that it has been our continued recommendation that some sort of formality be considered for these programs." Ex. J-226 at 1.

Regarding another control deficiency, Grant Thornton, through Koeppel, stated in an August 2006 letter to Koss that "overall controls appear to be designed effectively" but that Koss "currently has many detective and monitoring manual controls that identify problematic issues once they have already occurred. The risk in relying primarily on these types of controls is that they are detective instead of preventive in nature. The implementation of an increased number of preventative controls can further decrease the risk that material misstatements could occur." Ex. J-39 at 5. This point was made again in the corresponding letter to Koss in August 2007, as a "[r]ecommendation[] to strengthen internal control," rather than as an identified deficiency in internal control. Ex. J-132 at 4. This recommendation "that more automated and preventative controls be added" was addressed again in a 2008 audit planning work paper, which stated that VP-Finance responded that "there have been very few changes since PY [prior year]" and that "given the small size of the entity, correcting [this] deficienc[y] would simply not make sense from a cost-benefit perspective." Ex. R-393 at 2.

5. Koeppel Chose Not To Test Internal Controls Over Koss's Information Technology System, and Limitations of the System, as Koeppel Understood It, Impacted the Audit Work.

In planning the 2006, 2007, and 2008 Koss audits, Koeppel considered Koss's IT system as part of her effort to understand Koss's internal controls. Tr. 865-67, 1340-41 (Koeppel); Exs. R-202 at 6, R-295 at 4, R-393 at 5 (2006-2008 work papers). As with internal controls over financial statement assertions, however, Koeppel chose not to test the operating effectiveness of Koss's controls over its IT system for the audit period, explaining, "We audit the output of the system, rather than the system itself." Tr. 1336, 1473. Essentially, she operated during those audits on an understanding of Koss's IT system that was based on a 2004 review by Grant Thornton information technology specialists, based on subsequent audit team inquiry of Koss management and other personnel, observation on a particular day of certain Koss log-in and keystroke functions and end-of-the-day processes and review of documentation of the processing of some individual transactions as part of annual so-called walkthroughs of key controls over the revenue and inventory purchasing cycles, and based on experience using the output of the IT system in the audit work.[5/]

Part of Koeppel's understanding was that there were system limitations on access to financial data in Koss's electronic database. Tr. 789-90, 1329-30, 1347-48; KPHS 28, 60. As discussed below, such limitations complicated the audit tasks of obtaining a complete population of journal entries for fraud testing and supporting the reliability of Koss's system-generated reports used in the substantive audit testing of Koss's recorded revenue and inventory. *See, e.g.*, Exs. D-4 at 88 & R-509 at 124 (Audit Manager testified in investigation that "we cannot obtain an electronic version" and so "we were relying on the printouts of the system," but "[w]e were able to audit around it and get comfortable with things").

During the period of the audits, Koss used various standard software programs running on an IBM AS/400 computer. Tr. 1347 (Koeppel); *see* Ex. J-2 at 2 (2004 document carried over to 2006 audit); Ex. J-200 at 2 (2008 work paper). Koeppel described this as an "off-the-shelf system," which "was not complex," had "very little tailoring [to Koss] done within there," and "was so old [Koss] couldn't even get updates anymore." Tr. 1186, 1338-39, 1349, 1485-86; *see* Ex. R-509 at 167-69 (Audit Manager's investigative testimony). Although accounting department members and other Koss personnel entered financial data into the computer system, and VP-Finance

[5/] *E.g.,* Tr. 864, 1298, 1342, 1345 (Koeppel); Tr. 235-36, 290-291, 293, 295 (2006-2008 Staff/In-Charge Auditor: Koeppel's review of walkthrough); Exs. J-4, J-101, J-201 (2006-2008 audit memoranda summarizing interviews with VP-Finance and Senior Accountant about Koss's financial reporting controls); Exs. J-5, J-102, J-202 (2006-2008 audit memoranda on Koss's inventory expenditures process); Exs. J-6, J-103, J-203 (2006-2008 audit memoranda on Koss's revenue procedures); Ex. J-49 at 1, 4 ("GT selected 1 PO [purchase order] from an receipts register" and "1 invoice from an A/R register" and reviewed records of those already processed February 2006 transactions as part of July 12, 2006 walkthrough); Ex. R-300 at 15, 16, 21, 23, 31, Tr. 294-95, 390-392 (review of Koss records for one already processed $66.09 credit memo, $2,205.20 sale, and $21.11 warranty claim and observation of Senior Auditor matching individual credit memos to Koss credit memo report at day's end, as part of June 4-7, 2007 walkthrough); Ex. R-398 at 7, 8, 15, 20, 22, Tr. 701 (review of Koss records related to one already processed sale, inventory purchase, and warranty claim as part of June 3-4, 2008 walkthrough); Exs. R-205, R-299, R-396 (2006-2008 Koss audit memoranda summarizing conversations with VP-Finance about Koss's governance controls); Exs. R-298, R-397 (2007, 2008 "Who Performs Processes and Controls" work papers), Tr. 284.

or Senior Accountant were responsible for regularly reconciling subledgers with the general ledger and with paper records, Koss outsourced administrative responsibility for managing the computer system and programs to a third-party contractor. Tr. 46-48, 99-100, 1300; Ex. J-2 at 2, 5; Exs. R-205 at 4, R-299 at 4, R-396 at 4 (work papers).

Among other accounting data Koss maintained on its computer system was its general ledger, a compilation of all transactions recorded in the company's general ledger account. Koss also used electronic subsidiary ledgers to record various accounting transactions, including accounts receivable, accounts payable, and inventory. *E.g*., Tr. 187-88 (2006-2008 Staff/In-Charge Auditor); Ex. J-2 at 2, Ex. J-5 at 5, 6, Ex. J-6 at 2-6 (2006 audit work papers); Ex. J-200 at 2 (2008 audit work paper). Although the auditors did not observe the process, they understood that entries from Koss's subledgers were posted to its general ledger as "standard" journal entries on a monthly basis through an automated program that was initiated by the accounting department. *See, e.g.,* Tr. 563-64 (the process of posting from the accounts receivable subledger to the general ledger was not automatic), 698 (understanding of process based on discussion with member of accounting department, not observation) (2007-2008 Staff Auditor); Tr. 1961 (Koeppel's expert); Exs. J-49 at 1, 4, R-300 at 6, R-398 at 11. For example, they believed, sales transactions were accumulated in the accounts receivable subledger and posted to the general ledger monthly, and, although not observed or reviewed by them, reconciliations between the two were performed by that department on a monthly basis. And the auditors were aware that the department could post manual "nonstandard" journal entries directly to Koss's electronic general ledger, bypassing the respective subledgers. Tr. 49-50, 62-63, 77-78 (2006-2008 Staff/In-Charge Auditor); Tr. 698 (2007-2008 Staff Auditor); Ex. D-4 at 40, 58-59, 94, 115 (Audit Manager's investigative testimony); Exs. J-4 at 2, J-101 at 2, J-201 at 2 (2006-2008 audit memoranda); Ex. J-7, Ex. J-10 at 1-2, Ex. J-11 (2006 audit work papers).

In planning each audit in question, Koeppel concluded that the potential that Koss's financial statements were materially misstated due to errors in its accounting system was low and that the general inherent risk indicator of ineffective accounting or information systems was not applicable. *See* Tr. 1188; *see also* Exs. J-70 at 2, J-178 at 2, J-278 at 2 & Exs. J-72, J-180, J-275 (2006-2008 work papers). A 2008 Koss audit planning document approved by her stated that the AS/400 is a "reputable system[] that ha[s] proven reliable for many companies across various industries," and, "[a]s such, GT considers there to be a very low risk of systematic errors produced by the accounting systems." Ex. J-200 at 2, 7. In this regard, Koeppel testified she took comfort from her belief that Koss was "using the same [computer keystroke] inquiries to generate reports repeatedly," that the inquiries "were standard, or if they had been customized, they had been customized years before," and that Koss "didn't have complex transactions to process." Tr. 1485-88. She also cited "overall access controls to the system" that she believed were in place at Koss, based on audit team inquiry of Koss and its third-party IT contractor, observation of certain system users during the walkthroughs, and testing of selected Koss journal entries. Tr. 1342, 1349, 1489; *see* Tr. 523 (2007-2008 Staff Auditor); Ex. J-7; Exs. J-10, J-105, J-205; Exs. J-49, R-300, R-398; Exs. R-298, R-397.

Koeppel also stressed her understanding that Koss had an "integrated system," consistent with double-entry bookkeeping, in which, for example, "when a [Koss] shipment occurred, [its computer system automatically] relieved inventory and then also recorded the sale in accounts receivable" and "in revenue, when an invoice is generated, it hits sales and it hits accounts receivable [by automated application program]." Tr. 1186, 1349, 1357, 1360-61, 1397-99, 1465-66, 1489.[6/] Further, in investigative testimony, Audit Manager distinguished Koss's "centralized system" from a situation, for example, of "multiple location items" in which a company "had sales reports coming from various systems and various subsidiaries, and it was coming from a number of different sales reports to reconcile to the receivables and centralized billing in some cases and not in others." Ex. R-509 at 167-69. Additionally, Koeppel testified

[6/] *See, e.g.,* Tr. 121-22, 389-92 (2006-2008 Staff/In-Charge Auditor stated similar understanding); Exs. J-6 at 3-5, J-103 at 3-4, J-203 at 3-4 (audit memoranda: based on discussions with Koss's accounting department, "there is an integrated database between the sales order and invoicing applications"; recording shipment of goods in inventory subsystem "automatically relieves inventory and records the accounts receivable subsidiary ledger"); Exs. J-5 at 5, 6, J-102 at 6, J-202 at 6 (audit memoranda: based on inquiry, "Upon printing checks, the system will remove the payable amounts. As such, it is deemed that the databases are integrated."); Ex. J-49 (2006 Internal Control Walkthrough document) at 4 (based on inquiry, "Shipping documents are sent to AR to record shipment and generate the invoice which posts AR, inventory, sales, and [cost of goods sold]."); R-300 (2007 Walkthrough Test Summary Report) at 8 ("GT viewed the AP ledger noting once an invoice is paid it is automatically removed from the AP ledger."), 25 ("The AS/400 is a fully integrated system. Once goods are shipped and updated in the system by the shipping department, the invoice is automatically released and can be generated. GT observed this process."), 23 & 27 ("Once the invoice is generated, it is automatically recorded in the accounts rec[ei]vable subsystem"; claims "GT observed this process" on June 5, 2007 but "using [an] invoice" dated April 12, 2007, leaving only other stated basis "interview[]" with Senior Accountant), 27-28 ("GT observed a screen shot of th[e] process" whereby the AS/400 system "automatically checks the individual transactions against batch totals"); Ex. R-398 (2008 Walkthrough Test Summary Report) at 12 ("integrated database between payables and payment applications"; no source cited other than interview), 22 & 24-25 ("GT notes the AR is automatically posted when the invoice is generated."; although states that "GT observed [on June 4, 2008] the posting of the AR through the Transaction Information entered [for a particular sale]," payment for that sale is listed as received on May 19, 2008, leaving only other stated basis as "interview[]" with Senior Accountant); Exs. R-298 at 2-4, 7-9 & R-397 at 2-4, 7-8 (2007, 2008 "Who Performs Processes and Controls" documentation; similar information, based on audit inquiry).

that she believed that "[h]aving a third-party provider, in itself, provided a level of comfort, because you have separated activities." Tr. 1342.[7/]

In considering Koss's IT system, Koeppel testified she relied on "the foundational work" of Grant Thornton IT specialists brought in to obtain an understanding of that system in connection with the firm's first audit of Koss in 2004. Tr. 862-63, 864-67, 1342, 1345. Documentation of that 2004 IT review took the form of a six-page "IT Question[n]aire" and a 19-page July 2, 2004 "Summary Review Memo." The stated objectives of the IT review were described as follows in the IT review memo: (1) to "[a]ssist the financial audit team in assessing the Company's overall control environment," (2) to "[d]etermine if it would be possible to rely on program change, database administration, and user access controls," (3) to "[a]ssess the Company's use of leading IT management practices," and (4) to communicate findings, conclusions, and any recommendations for improvement to the audit team and Koss management.

The IT questionnaire (Ex. J-1) identified controls said to be in place within Koss's IT system in the areas of (1) management and organization (develop and implement plans, identify and assess risks, operate reliable systems, hire and retain people, and manage third-party services, with two to four highly general controls listed for each); (2) applications (acquire and maintain operating and database systems (four controls listed relating to software upgrades) and acquire and maintain applications (nine controls relating to development projects and programmer access); and (3) security (administer policies and procedures (five controls), protect data and enforce segregation of duties (11 controls relating to use of user and group profiles, identifications, and passwords), limit external access to systems (11 controls), protect physical assets (six controls)). This was "followed by a narrative that gives a little bit more background on the discussion that was had with the individuals at Koss to determine this." Tr. 1343.

[7/] *See* Tr. 1330 (asserting that Koss "used very credible third-party specialists to oversee their IT department"); Ex. J-2 at 1 (according to a 2004 Grant Thornton review of Koss's IT system, the IT staff "is outsourced to two main individuals," described as "knowledgeable and helpful"); Ex. R-202 at 6 (2006 work paper: "Management of the information systems is outsourced….As such, the potential for internal 'tinkering' with the system is limited. See journal entry testing for the testing of the posting and approval of journal entries."); Ex. J-100 at 4 (2007: "The use of IT processing adds some additional risks of the susceptibility of information. GT will discuss the potential of risks with management. [Per discussion with Junior Accountant], management of the information systems is outsourced. As such, the potential for internal 'tinkering' with the system is limited."); Ex. J-200 at 2, 7 (2008: Koss "performs some internal IT processing which adds additional IT risks as it relates to the susceptibility of altering information. However, Koss has outsourced the management of such systems to offset the risk of internal 'tinkering' with the systems. GT therefore considers there to be a very low risk of man-made errors in the accounting systems.").

After stating the objectives, the IT review memo noted, “We reviewed the [Koss IT] systems as communicated by the client,” and specified these procedures as having been performed: “Inquiry of outsourced IT personnel,” including meeting with those two individuals; “Tour of the Milwaukee computer room”; “Review of selected client documents”; and “Testing the IBM AS/400 user profiles for previous sign-on attempts, sign-on attempts not valid, and status.” Ex. J-2 at 1. It is undisputed that the 2004 IT review was not a test of the operating effectiveness of the internal controls over the IT system for 2004 or any of the three years at issue. *See, e.g.*, KOB 27; Tr. 1342, 1473.

The body of the IT review memo began with summary descriptions of Koss’s computer hardware and software, the organization of Koss’s IT department, and the vendors who provided support for that department. Then the memo: (1) discussed Koss’s “General Computer Controls” (“Planning,” “Developing,” and “Operating”); (2) noted that “[d]uring the IT Controls Review, we collected user profiles for the IBM AS/400 in the network,” “observed 48 user profiles,” and “found that 12 users had not signed onto the system in over a year and that their profiles were still enabled,” though two were then disabled, three others had been “automatically created for the latest software release” and “cannot be accessed by users,” and a “compensating control does exist in that passwords expire after 90 days,” so the seven other identified users “will have to contact the AS/400 Administrator to gain access”; (3) made three pairs of overall findings and recommendations, characterizing one issue as “Moderate Risk” (lack of formal procedures for changes to Koss’s database by its outside administrators) and the other two issues as “Low Risk” (one: lack of regular reviews of user access and segregation of IT duties and failing to disable inactive user profiles; two: certain areas for improvement in Koss’s user identification and password policies, which “d[id] not consistently follow leading practices”) and noting, and in one instance commenting on, Koss management’s responses; (4) offered four lesser “Observations” (suggesting that Koss should continue its effort to “develop a formal disaster recovery / business resumption plan to anticipate operational problems related to IT system failures,” “consider keeping the door to the computer room closed and locked at all times,” “confirm[] the effectiveness of controls around [the] IT process” of a vendor that serviced the “electronic commerce website” on which Koss then did a level of business “not considered material to [its] financial statements,” and formalize Koss’s computer help desk function); and (5) stated “Additional Management responses” and a “Reviewer Comment.” Ex. J-2 at 2-18. The memo also included a “Conclusion” section. *Id.* at 1.

The IT review memo set forth the following as its “Conclusion” (*see id.* at 1, 2), including critiques of Koss’s internal controls over the IT system:

> The Company has IT processes in place for managing program changes, managing access to production data around application controls, and managing user access to the Company’s CRT software system [used for Koss’s “Accounting (AP, AR, GL), Order Entry, Sales Reporting, Invoicing, Distribution, Payroll” functions]. The controls related to those processes

> appear to be primarily detective rather than preventative, although regular reviews of detective controls suggest that these controls are probably ineffective. The IT vendors appear focused at functionality with little understanding or appreciation of IT control standards. In addition, Company management appears to rely completely on the IT vendors.

Regarding those outside personnel, among the findings in the IT questionnaire was that Koss's "IT management (vendors) do not appear to fully understand IT control standards" and "do not provide the Company with formal third party attestations" that "could confirm their understanding and use of leading IT Controls." Ex. J-1 at 1, 3.

The Grant Thornton IT specialists also found that Koss "does not perform regular user access / segregation of [IT] duties reviews" and that, "[a]s a result, some users may have excessive access to the Company's financial systems." Ex. J-2 at 15; *see id.* at 12; Ex. J-1 at 5. The IT review memo recommended not only that "a policy be established to review and disable inactive AS/400 users, despite their status or title," but also that "the IT department prepare quarterly user access lists that can be reviewed for inappropriate access rights by department managers / vice presidents." Ex. J-2 at 15. As to user access, management responded that "[t]here are 20 users and very little turnover" and "[m]aybe 5 are here less than 3 years," concluding that "I would rate this low risk…On a scale of 0 to 10 this is maybe a 2." As to segregation of duties, management responded, "The operative word is may have in the sentence about having excessive access. I think the recommendation is appropriate and once again I think this is low risk. On a scale of 0 to 10 it [is] maybe a 1." As to the number of user profiles in the system, management responded there were 55 live user profiles that were not "software and operating system related" profiles inaccessible to users, and concluded, "Once again I think this is low risk. On a scale of 0 to 10 this is maybe a 1." *Id.*

In reply to these points, the IT review memo stated, "User access is a key control in an IT environment. Segregation of duties is a primary consideration and requires multiple individuals be involved in all material transactions, including granting access rights to material processes." According to the memo, "Executive management's (CEO, CFO, CIO, etc.) ability to administer user access and grant transactional rights is a consideration because this right suggests that one individual with extraordinary authority can alone grant access rights. The ability of any one individual to grant access rights without oversight, regardless of position, is an inappropriate segregation of duties." The memo's reply to management concluded, "Regular reviews of user access can act as an appropriate control in a small user environment. The number of users or the frequency of turnover is not a control when assessing the effectiveness of segregation of duties and user access controls." *Id.* at 15-16.

Furthermore, the IT review memo contained an exchange between Koss management and the Grant Thornton IT specialists that indicated that management placed a high degree of responsibility on its personnel at the departmental level and that its business perspective diverged from an audit perspective on internal controls. Specifically, management stated, "I think it is important to note our IT is in the hands of the users. Each area is responsible for it[s] data and the accuracy of that data." According to management, "There are controls in place where we know daily if something is out of sorts. We have backup systems in place and security systems in place which have been utilized and allow us to smoothly move through a problem when it occurs." Management concluded, "The books have been accurately closed on the first day of the month for over 10 years. I say this because it is an affirmation of a well oiled machine." *Id.* at 17. The IT reviewer commented in reply, "Auditing standards focus on IT Governance and controls rather than how 'well oiled' the process may seem. Reviews of this Company's IT controls by regulators, investors, or buyers would find control gaps that would be unacceptable based on IT control standards." *Id.* at 18.

Koeppel testified that the purpose for which she used the 2004 IT review in each Koss audit was to "determine whether or not the IT system had deficiencies that we needed to take into consideration in connection with planning and performing our audit." Tr. 862-67. According to Koeppel, she "took these two documents in their entirety" but "focused on" the recommendation portion of the memo. *Id.* at 866-67. She stated that any IT system deficiencies would have been identified in each audit's documented understanding of controls and in the Summary of Control Findings, a document which formed the basis for a Grant Thornton communication each year to Koss. Tr. 1179-80, 1346-47; *see* Tr. 297-98 (2006-2008 Staff/In-Charge Auditor). Yet, Koeppel asserted, no deficiencies in controls over IT systems were identified in the 2006, 2007, and 2008 Koss audits that rose "to a level beyond [that] of a control deficiency that we provided to management," except for the 2004 IT review's observation that Koss lacked a formal disaster recovery plan (Ex. 1 at 2; Ex. J-2 at 17), which Koeppel regarded as a "prospective issue" that did not "directly impact the financial reporting system of the period we're auditing." Tr. 1343-44; *see* Exs. J-38, J-225 (2006, 2008 work papers); Exs. J-39 at 3-6, J-132 at 3-4, J-239 at 7 (2006-2008 communications to Koss).

As Koeppel describes it, the information from the 2004 IT review was carried forward in the 2006, 2007, and 2008 audits as a "good foundation" for understanding Koss's internal controls over its IT system. Tr. 862-64, 1345, 1348; *see, e.g.*, Ex. J-1 at 7 & J-2 at 20 (2004 IT questionnaire and memo included in 2006 audit work papers). She testified that over the audit years in question "[w]e had discussions" with the third-party administrator of Koss's IT system, as well as with Koss personnel, "about whether or not they made any changes to their system"; observed the processing of some individual Koss transactions; examined the records of how selected journal entries were processed; inquired about "the expertise and experience of the individuals who were performing work" relevant to financial reporting and "whether there had been changes in the individuals…[or] in [their] responsibility"; noted that Koss was providing the same types of system-generated reports for each audit; and concluded that no significant changes had been made to the IT environment at Koss. Tr. 1186-87, 1298, 1342, 1345, 1347-48, 1488; *see, e.g.,* Tr. 233-35 (2006-2008 Staff/In-Charge Auditor); Ex. R-202 at

2 (“PDW [VP-Finance], the IT environment has not changed at all in the past few years. As such, the IT documentation from fis[c]al 2004 is still accurate.”); Exs. R-205 at 2 (initialed by Koeppel), R-299 at 1, R-396 at 1 (initialed by Koeppel) (2006-2008 audit planning memoranda: “Many of the individuals in financial reporting have been performing their responsibilities for a number of years.”).

Finally, Koeppel testified that, throughout the audits in question, she understood that IT system limitations affected auditor access to financial information maintained electronically by Koss. For audit purposes, she deemed an electronic copy or printout of Koss’s entire general ledger or detailed listing reports of particular general ledger accounts to be “definitely the preferred method to get the information.” Tr. 1330, KPHS 28, 65; *see* Tr. 412 (2006-2008 Staff/In-Charge Auditor: “ideally” would have those). But, as Koeppel explained it, based on audit team inquiries of Koss and its third-party AS/400 administrator and on experience with other audit clients of similar size, “older,” “basic systems” like Koss’s did not have the “kind of data access and search capabilities” that could produce an electronic download or computer-generated list of all general ledger entries for the year under audit. Tr. 789-90, 1329-31, 1483, 1487; *see* Tr. 99-100, 102, 106, 110-11 (2006-2008 Staff/In-Charge Auditor: per Koss’s accounting department and outside contractor, “it was a limitation in Koss’s software that prevented [Koss] from getting a download of all journal entries in electronic format” or printing a full list; Koss “couldn’t perform a query function” to do that); Tr. 522-23 (2007-2008 Staff/In-Charge Auditor); Ex. J-205 at 3 (2008 work paper: “[Per VP-Finance], the G/L system does not allow Koss to print out listing of journal entries recorded during the year.”).

Nor, according to Koeppel, could Koss’s IT system produce detailed listings of transactions recorded in particular general ledger accounts: “It was not a static system. So once time passed, you couldn’t go back and get the aggregate information. You had to walk through a series of [periodically printed] reports, because it was summarized…we knew they couldn’t go back and regenerate, for example, an accounts receivable report once time passed.” Tr. 1347-48; *see, e.g.*, Tr. 575-77, 583-84 (2007-2008 Staff Auditor: IT system could only provide a listing of sales for a one-day period; Koss would print out the invoice listing every day and accumulate them in a binder); Ex. J-125 at 3, 6 (2007 work paper: “Because of restrictions imposed by Koss’s accounting system, a detailed listing of all cash receipts and invoices could not be produced.”); Ex. J-48 at 3 (2006 work paper: “Koss cannot produce a[n] [inventory] purchases report”); Exs. J-55 at 2 & J-155 at 1 (2006, 2007 work papers: a detailed accounts payable listing by invoice “cannot be generated” by Koss’s IT system); Exs. J-54 at 5, J-153 at 4, J-250 at 6 (2006-2008 work papers: when used in audit testing, Koss fiscal year-end physical inventory report “was only in paper,” “is only available in paper form”). *See generally, e.g.,* AU § 311.09(d) (“Documents that are used to enter information into the computer for processing, certain computer files, and other evidential matter that may be required by the auditor may exist only for a short period or only in computer-readable form.”).

Although Koeppel knew that the auditors could directly view Koss's electronic general ledger at a Koss computer terminal, she testified it was her experience that the only way audit clients would allow this was for the auditor "to work with a member of accounting staff to obtain that access and to navigate through the system," with the auditor sitting at the computer screen next to the client's employee, who would operate the computer. Tr. 1322, 1324-25, 1328, 1332-33, 1491; *see* Tr. 523 (2007-2008 Staff/In-Charge Auditor); Ex. D-4 at 13-14 (Audit Manager's investigative testimony); Ex. J-302 at 5. Further, a junior member of the 2006, 2007, and 2008 Koss audit teams testified that when Koss's accounting staff "pulled up transactions" on the computer screen "and when you got to the detail of the journal entry, they only were able to show that transaction," so it "would have been hard" and "a very time-consuming process" to "go through every journal entry posted in a month or a week or a year." Tr. 415-16.

As we discuss, Koeppel was well aware that in substantive testing in the 2006, 2007, and 2008 audits, the auditors, citing system limitations, did not directly access Koss's electronic general ledger. She also knew they did not secure the assistance of a professional with specialized IT skills or apply computer-assisted audit techniques to help obtain a complete population of journal entries for testing or to help support both the completeness and accuracy of Koss's IT system-generated reports. *See, e.g.*, Tr. 1324; Ex. R-509 at 125-26 (Audit Manager's investigative testimony).[8/]

[8/] *See generally* AU §§ 311.10 ("a professional possessing" "specialized skills," who could be "either on the auditor's staff or an outside professional," could provide assistance "to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures"), 316.52 ("the auditor may choose to employ computer-assisted audit techniques to gather more extensive evidence about data contained in significant accounts or electronic transactions…[such] techniques may enable more extensive testing of electronic transactions and account files…[and] can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample"), 316.54 ("Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions."), 316.61 ("Electronic evidence often requires extraction of the desired data by an auditor with IT knowledge and skills or the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments to be tested."), 319.32 ("Procedures that the auditor may assign to a professional possessing IT skills include inquiring of an entity's IT personnel how data and transactions are initiated, recorded, processed, and reported and how IT controls are designed; inspecting systems documentation; observing the operation of IT controls; and planning and performing tests of IT controls."), 319.79 (as "computer-assisted audit techniques may be used to test automated controls or data related to assertions" and auditor "may use other automated tools or reports produced by IT to test the operating effectiveness of general controls, such as program change

Instead, as Koeppel knew, and as discussed below, the auditors relied on manually prepared journal entry forms, reports periodically generated by Koss's computer system of journal entries posted to the general ledger, and system-generated reports or spreadsheets of subsidiary ledger details and general ledger trial balances. As an audit team member for each of the pertinent years testified, "When we first got into the field on the first day, there was usually a stack of a ton of documents," including spreadsheets and reports, on which the auditors then went to work. Tr. 158-60 (2006-2008 Staff/In-Charge Auditor); *accord, e.g.*, Tr. 590-91 (2007-2008 Staff Auditor audited off of paper copies of trial balance or balance sheet provided by Koss).

6. While the 2006 Koss Audit Was Underway, Koeppel Received a PCAOB Inspection Comment on the 2005 Koss Audit That Focused Her Attention on the Issue of the Completeness of the Population of Journal Entries Selected for Fraud Testing.

Prior to completion of the 2006 Koss audit, the PCAOB conducted an inspection of Grant Thornton and reviewed components of selected issuer audits that had been completed by the firm, including the 2005 Koss audit. *E.g.*, R.D. 1 at 8 ¶ 24; R.D. 22 at 11-12. After that review of the 2005 Koss audit, PCAOB inspectors issued to the firm an inspection comment form, dated July 26, 2006, on that audit, which Koeppel received while field work on the 2006 Koss audit was ongoing. Tr. 413, 758-59, 762, 1490-92; Ex. D-1; Ex. D-4 at 18-19, 20, 25 (Audit Manager's investigative testimony); *see* Ex. J-59 at 1, 25 (audit report on Koss's fiscal-year-2006 financial statements was dated August 30, 2006 and filed by the company with the SEC on September 6, 2006).

The comment form stated, under the heading "Facts" (Ex. D-1 at 1):

> The engagement team's fraud audit procedures consisted of a review of the journal entries for the month of June, noting no unusual or improper entries included in the monthly binder of standard and non-standard journal entries maintained by the issuer. The team noted the examination of journal entry worksheets focusing on high-dollar entries and non-standard journal entries, noting whether entries had a proper approval and support. The actual identification of the entries and the tests performed were not documented in the audit work papers.
>
> The engagement team did not perform procedures to determine whether the data represented a complete population of journal entries.

controls, access controls, and system software controls," auditor "should consider whether specialized skills are needed to design and perform such tests of controls").

In connection with completing and returning the form to the PCAOB, Koeppel signed at the bottom of this section of the form as the "Firm Representative," acknowledging that she had "read the facts as presented above and agree[s]."

The PCAOB inspection comment continued, under the heading "Issue" (*id.*):

> The engagement team's procedures were not sufficient to comply with AU 316, *Consideration [of] Fraud in a Financial Statement Audit*, in that they did not include the following or did not include documentation of why such procedures were unnecessary:
>
> - Ensuring the completeness or accuracy of the data population
> - Testing of journal entries from throughout the period
>
> In addition, for those journal entry procedures that were performed, the engagement team's documentation was insufficient to comply with Auditing Standard No. 3, *Audit Documentation*, as it did not include documentation of the journal entries selected for testing.

To this section of the comment form, Grant Thornton submitted the following response:

> [An audit work paper] outlines that we reviewed the journal entry binders maintained by the client and reviewed all entries. The documentation, however, does not list each individual entry[,] as we looked at all entries. The process for accumulating all entries in the binder and the lack of issues noted during the testing of reconciliations and other audit work allowed us to conclude that the journal entry binders we reviewed were complete.
>
> Additional documentation is warranted.

Id. at 2. Under the heading "Firm's Remedial Action(s)," it was further stated on behalf of the firm that (*id.*):

> To supplement the work previously performed over the journal entry testing, the engagement team will detail the specific entries reviewed; document unusual items noted for the specific entries evaluated[;] and complete an assessment (upstream/downstream testing) as to the completeness of the journal entries provided.

Koeppel signed as the "Firm Representative Responsible for the Firm's Response and/or Remedial Action(s)." *Id.*; Tr. 766. According to her, that was the only description of the remedial procedures that was provided to the PCAOB inspectors. KPHS 31.

Koeppel testified that the statements made on behalf of Grant Thornton on the comment form reflected her discussions with the Audit Manager and others at the firm, some of whom reviewed the form before it was submitted to the PCAOB. The others were the managing partner of the firm's Milwaukee office, who was also a concurring partner on the 2005 Koss audit; the local professional standards partner; the regional professional standards partner; and two partners in the audit practice quality group. Tr. 1319-20, 1326. Koeppel made the judgment that the idea of "upstream/downstream testing" was, in her words, "an effective way of testing the completeness of the information," "mak[ing] sure we had a complete set of journal entries," and "get[ting] comfortable" about the completeness of the population from which to select entries for fraud testing, after discussing with the regional professional standards partner "the fact that we couldn't get an electronic download" of Koss's general ledger and that its journal entries were not "numbered sequentially." Tr. 1322-23, 1329. In Koeppel's view, the idea of "sending [Grant Thornton's] IT advisory group out to Koss to check" on the system limitations "never came up" because "we had clients who had older systems and these kind of limitations were not unique to Koss." Tr. 1324; *see* Tr. 800, 1483-87.

As Koeppel testified, "[n]obody discussed with" her or Audit Manager "one specified way of doing" the so-called upstream/downstream testing or "the variety of procedures that we could use" to determine the completeness of the journal entry binders at Koss. Tr. 1322-24, 1452-55. Koeppel did not discuss with Audit Manager why Audit Manager ultimately chose a certain approach for 2005 or later audits or discuss that approach with anyone else, nor was it revealed by the firm's statements on the inspection comment form, which did not describe how that testing would be performed; and Koeppel never asked anyone outside of the audit teams to review the remedial work on the 2005 audit or the different "upstream/downstream testing" used in the 2006, 2007, and 2008 Koss audits before authorizing issuance of the audit reports for those years because she "did not see a need to elevate that to somebody outside of the engagement team." Tr. 766-71, 1452-55, 1491-92; *see* Tr. 767-68 (noting that "[t]here's multiple ways to perform upstream/downstream testing" and that it did not necessarily "include[] taking a selection of journal entries from journal entry binders maintained by the client and tracing them to the system"). Although Koeppel has stated that in late 2006 or early 2007, a partner in the audit practice quality group requested and received copies of the remediation work papers and that Koeppel heard nothing further about that at the time, the "upstream/downstream testing" used for the remedial work, unlike the testing by that name used in the 2006 to 2008 Koss audits, did not rely exclusively on paper records from Koss. *E.g.*, Tr. 768-71, 1325-29, 1490-92 (Koeppel).

The remedial work for the 2005 audit was performed by Audit Manager and reviewed and approved by Koeppel in September 2006. Tr. 768-70, 1157-58, 1327-28, 1491 (Koeppel); Ex. D-4 at 15 (Audit Manager's investigative testimony); Ex. J-302. To do the so-called upstream/downstream testing, Audit Manager "obtained all of the fiscal 2005 journal entry binders" from VP-Finance. Ex. J-302 at 5; Ex. D-4 at 13. A July 8, 2005 work paper from the 2005 Koss audit described these binders, based on a discussion with VP-Finance: "Koss maintains a binder of standard and non-standard journal entries for each month of the fiscal year. There is a journal entry checklist…for all standard monthly journal entries. Journal entries are manually recorded on journal worksheets detailing the accounts affected by the entity and the corresponding amounts recorded to each account. In most cases, documentation supporting the entry is attached to the back of the journal entry worksheet." Ex. R-141.

Koss's standard journal entries have been described by audit team members as automated or manual and typically "happen[ing] on a recurring basis," such as "when inventory is sold, the release of inventory," "the posting of depreciation expense that is going to be of a recurring, routine nature of a similar amount based on an activity that's in place," or "an automated posting or uploading of accounts payable from a subledger to the general ledger," "initiated by an employee." Koss's nonstandard journal entries were depicted by those auditors as "of unique nature for typically a specific transaction" or "things that would not be recorded on a routine basis or less frequently than on a monthly basis," such as an entry "to increase an accrual," for which "there's a manual journal entry form, someone keys it in" by computer. Tr. 62-63, 77-78 (2006-2008 Staff/In-Charge Auditor); Ex. D-4 at 38-40 (Audit Manager's investigative testimony).[9/]

For the remedial work, Audit Manager selected five items, all standard journal entries, from the monthly form binders and "had [Senior Accountant at Koss] put in the journal entry number and pulled it up on [Koss's electronic general ledger] accounting system and saw that the information on the screen matched what was in the binder." Audit Manager "then randomly selected a journal entry number from various months"—again constituting five standard journal entries—"and had [Senior Accountant] pull that up on the screen, saw the details there, and then went and looked in the binders, also noting that the items in the binders going in the other direction agreed." Ex. D-4 at 13-14 (Audit Manager's investigative testimony); *see* Tr. 1322, 1324-25, 1328, 1491 (Koeppel); Ex. J-302 at 5. As will be discussed below, the "upstream/downstream testing" performed in the 2006 to 2008 Koss audits relied on using a second set of paper records instead of viewing Koss's electronic general ledger.

Koeppel has represented in this proceeding that she had the inspectors' concerns about the completeness of the journal entry population in mind not only in

[9/] *See generally* AU § 319.51 (an entity's financial reporting process used to prepare the financial statements typically includes (1) "the use of standard journal entries that are required on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record accounting estimates that are periodically made by management such as changes in the estimate of uncollectible accounts receivable" and (2) "the use of nonstandard journal entries to record nonrecurring or unusual transactions or adjustments such as a business combination or disposal, or a nonrecurring estimate such as an asset impairment").

reviewing and approving the remedial work for the 2005 Koss audit but also in leading the 2006 audit, which was in progress when those concerns were expressed, and the 2007 and 2008 audits. Tr. 766, 813-14, 1325, 1327, 1329, 1490-91; KPHS 31, 69.

7. Koeppel Attended Firm-Wide Training in 2006 and 2007 That Highlighted the Importance of Obtaining a Complete Population of Journal Entries for Fraud Testing and the Risk of Relying on Management-Provided Lists or Binders of Journal Entries.

In testimony, Koeppel referred to "the years of training that I've had over journal entries." Tr. 1330. In particular, in August 2006 and in January 2007, Grant Thornton conducted, and Koeppel attended, firm-wide training that discussed findings from recent PCAOB inspections in which firm audits had been reviewed. Tr. 795-808 (Koeppel); Ex. D-4 at 25-28 (Audit Manager's investigative testimony); Ex. J-306; Ex. J-130. This training included a module on journal entry testing. Ex. J-130; Ex. D-4 at 26-27.

At the time of the 2006, 2007, and 2008 Koss audits, Koeppel believed that, as the training instructed, auditors "must address completeness" of the population used to select journal entries for fraud testing. *See, e.g.*, Ex. J-130 at 4, 20; Tr. 801-04 (Koeppel). A training slide stressed, "We need to make sure the population is the **entire** population." Ex. J-130 at 20 (bold in original). This statement was underscored in the slide's speaker notes, which observed: "If you do a good job testing journal entries but you never had the full list of journal entries, what have you accomplished? Don't waste your time on an incomplete file!" *Id.* Koeppel agreed with these points, too, during the audits in question. Tr. 802-05. Another training slide specifically warned that when management creates a listing of journal entries or provides paper copies of journal entries maintained in a binder for the auditor, "if there was fraud, management probably would not include the fraudulent entries" on the list and "[c]opies of fraudulent journal entries would likely not be in the binder." Ex. J-130 at 21-22. Koeppel testified that this slide also reflected her view at the time of the audits. Tr. 805-08.

B. The Performance Of The Audits In Question

Koeppel led the conduct of the 2006, 2007, and 2008 audits, and, in particular, reviewed certain work papers in areas of higher risk. *See, e.g.*, Tr. 747-53, 1157-58.

1. Journal entries

Koeppel approved each audit's approach to testing Koss's journal entries, and, in particular, "was aware of the procedures that we performed" to "make sure we had a complete set of journal entries." *E.g.*, Tr. 774-75, 778-79, 785-87, 790-92, 808-09, 813-14, 818-19, 822-23, 829, 832, 835-37, 1144, 1185-86, 1327-29, 1336 (Koeppel); KPHS 28, 30, 32, 65-71; Exs. J-3 at 1, 3, J-100 at 1, 3, 6, J-200 at 1, 3, 4, 7 (documenting 2006-2008 audit planning discussions led by Koeppel); Ex. R-300 at 6, 33 (section of

2007 walkthrough summary, initialed by Koeppel, making reference to authority and access controls as to journal entries); Exs. J-7, J-8, J-9, J-73 (2006 audit program for journal entry control testing and audit step responses initialed by Koeppel); Exs. J-10 at 1, 4, R-465 at 1, 4 (2006, 2008 journal entry control testing work papers initialed by Koeppel); *see* Tr. 92, 290-91, 411-12 (2006-2008 Staff/In-Charge Auditor); *see also, e.g.,* Tr. 335-40 (outlining 2007 audit program on journal entry testing). Koeppel testified that she understood at the time of the audits that PCAOB standards provided that the auditor's procedures should include selecting journal entries from the general ledger and understood that it was necessary to obtain a complete population of journal entries to perform journal entry testing. Tr. 764-65, 772-77, 792-94, 802-05; *see* I.D. 34. As Audit Manager summarized in investigative testimony, "[t]he journal entry testing is a fraud test, one of the few specific fraud tests that are required by professional standards," and "we were looking to validate" that "we were given a complete listing of journal entries to test and evaluate, looking at who posted and who authorized, and that there was appropriate support for the ones that were noted." Ex. D-4 at 82.

The approach followed in the three audits included what Koeppel described as testing journal entry controls in place at Koss, based on an understanding of them gained in audit planning. The work papers for each audit contained a memorandum by a junior audit team member, dated between late April and early June, stating that "Koss has policies and procedures established for financial reporting responsibilities and security access" and summarizing an interview with VP-Finance and Senior Accountant, in part about recording journal entries. According to each memorandum, those two individuals "have access to create standard and non-standard JE's." Senior Accountant "posts" or "books" "all entries." No other users have access to book entries, it stated, specifically attributing that statement in 2007 and 2008 to VP-Finance. The memoranda further stated that "[President/CEO] and [VP-Finance] review all entries booked each month and at year-end before the final statements" (2006) or "booked for the month" (2007, 2008) and that Senior Accountant compiles, and VP-Finance and President/CEO review, "the interim and year-end financial statements." Exs. J-4 at 1, 2, 3 (2006, initialed by Koeppel), J-101 at 1, 2 (2007), Ex. J-201 at 1, 2, 3 (2008, initialed by Koeppel); *see* Exs. R-202 at 3-4, 9, R-295 at 3, 6, R-393 at 3-4, 6 (each year's audit plan, approved by Koeppel, to which financial reporting controls memorandum and others attached under work step "[u]nderstanding and documenting internal control"); Tr. 279-80; Tr. 508-10 (2007-2008 Staff/In-Charge Auditor); Ex. D-4 at 37-54.[10/]

[10/] In each audit, the financial reporting controls memorandum was cross-referenced in a work paper purporting to document an understanding, but not any testing of the operating effectiveness over the year, of Koss's internal controls for "Record standard recurring and consolidating journal entries" and "Record non-standard journal entries." *E.g.*, Tr. 1288-94, 1467-73 (Koeppel); Tr. 533-35 (2007-2008 Staff/In-Charge Auditor); Tr. 690 (2007-2008 Staff Auditor); Ex. D-4 at 53-55 (Audit Manager's investigative testimony). For these processes, the work paper, without discussion, listed and checked boxes next to eight items: "Authorization policies and procedures understood

A notation on a 2006 Koss audit program elaborated on this understanding, in effect, by stating based on discussion with VP-Finance that "only [Junior Accountant and Senior Accountant] can initiate and record journal entries" and that "[a]ll journal entries are authorized by" VP-Finance. Ex. J-7; *see* Tr. 1143, 1149 (Koeppel); Ex. R-509 at 94-95 (Audit Manager's investigative testimony). Similarly, a notation on the 2007 audit program stated, per discussion with Senior Accountant, that VP-Finance "rev[ie]ws all standard and non-standard JE." Ex. J-104.

An understanding of Koss's journal entry process was also expressed in a memorandum on "Journal Entry Review," initially dated May 16, 2006 (a day after the financial reporting controls memorandum), authored by a different junior audit team member, and updated on August 28, 2006. This second memorandum declared, "GT notes that all journal entries are created on paper by" VP-Finance "and entered into the system by" Junior Accountant. President/CEO "reviews [VP-Finance's] journal entries through review of the monthly financial statements." Ex. J-11 at 4.

Addressing the two memoranda in investigative testimony, Audit Manager first explained that VP-Finance "had the ability" to post entries in the general ledger, but "[b]ased on our understanding of their policies and procedures, any entries that were created by" her—that "she would post and review"—"needed to be approved and reviewed by" President/CEO. Ex. D-4 at 40-44 ("Based on our understanding of the policies and procedures, any entries that were created by [VP-Finance] th[e] [President/CEO] would review, as it relates to things that she would post and review. In our testing of journal entry testing, I do not recall seeing any that [VP-Finance] generate[d] or created. She was typically the reviewer, based on the samples that we tested.") (emphasis added), 52. Later in the questioning, however, Audit Manager expressed the belief that it "may be inaccurate" or "was not entirely accurate" to say VP-Finance had "the ability to access and create" journal entries "because of the additional testing and looking at the IT profiles" that was done in the 2006 audit. Ex. R-509 at 140-41. Audit Manager further claimed, based on the testing of a sample of journal entries in each audit, that the second memorandum's statement that all journal entries were created on paper by VP-Finance "was a typo." *Id*. at 138. That is, "[b]ased on certain calculations in certain areas, it was possible that they [Koss's accounting department] were outlining what the calculations and what the entry was that should be recorded"

and communicated"; "Policies and procedures established"; "Security access controls restrict access to appropriate people"; "Comparing actual to expected results and followup of exceptions"; "Security access controls restrict ability to record journal entries to appropriate people"; "Manual authorization of journal entries"; "Periodic observation of operational controls"; "Duties of senior financial reporting personnel do not include the ability to make journal entries." Exs. R-274 at 252, 262, 819, R-379 at 244, 254, R-482 at 324, 334, 718; *see* Tr. 1307-10; Tr. 236, 246-49, 258-59.

and VP-Finance "may work on the origination and tell individuals what the entries needed to be," but "based on support that we saw in the binders" of these paper records of journal entries provided by Koss's accounting department, Junior Accountant or Senior Accountant "booked the entries, [VP-Finance] reviewed them, [so] based on testing, while [VP-Finance] had some involvement, she wasn't the only one" and if "she wrote them up on paper," they "were entered by others and [she] looked at the details." *Id.* at 135-37, 139, 142-44; Ex. D-4 at 47-48.

Yet the statements in the financial reporting controls memorandum about VP-Finance's access to create journal entries and Junior Accountant's lack of access to book or post journal entries persisted throughout all three audits. This was despite the fact that the document was "provided to management in this form asking them to review and update and provide back to us as well as the follow-up inquiries" and review. Ex. D-4 at 50; *see* Tr. 249-50, 289 (2006-2008 Staff/In-Charge Auditor); Ex. R-202 at 4 (2006: "These memos [attached to audit plan, including the one on reporting controls] were reviewed and updated by [Senior Accountant] and [VP-Finance] at prelim.").

Koeppel testified that she considered President/CEO to be part of Koss's overall internal controls over the journal entry process. Tr. 1448. According to Koeppel, in her experience with him, he appeared to be "very active and very knowledgeable" when it came to Koss's financial performance and "very involved" in reviewing its financial information, with a "significant interest" economically in "the operations and financial aspects of the company" due to its "compensation program" and the family's ownership of "about 75 percent of [its] shares." Tr. 1219-22, 1449. Another audit team member testified that President/CEO made general statements that he was "very involved with day-to-day operations, so he was well aware of things that were going on," and she believed he was "very involved in the company as a whole and in the financial statements." Tr. 96, 264-65 (2006-2008 Staff/In-Charge Auditor). According to Audit Manager's investigative testimony, in "our discussions with [President/CEO] over the financial statements in any period, he was very well versed in the financial statements and the requirements of such," "[h]e surrounded himself by individuals who were accountants," and "[w]hen there were any questions or doubts, he asked intelligent questions to make sure he had a thorough understanding." Ex. R-509 at 55.

Nevertheless, President/CEO "did not profess to be a GAAP expert" and was not an accountant by training. *Id.* Koeppel generally understood that President/CEO reviewed journal entries only on occasion, she could not recall him ever telling her that he reviewed journal entries monthly, she did not know how he would have conducted any review of individual entries, and she was not aware of any documentation of such a review. Tr. 1448-50. This was consistent with another audit team member's testimony that President/CEO said he reviewed journal entries "on a topside" basis, "through review of the financial statements or through review of supporting documentation. He didn't specifically look at every one." Tr. 251-52, 263-65 (2006-2008 Staff/In-Charge Auditor). Otherwise, that auditor elicited from President/CEO only general statements that he had "comfort in the journal entry process." Tr. 93-96. She did not specifically discuss with him the way the accounting department maintained records of the journal entries or how he would have reviewed any individual entries. Tr. 93-96, 101, 263-64.

Audit Manager testified in the investigation that she understood President/CEO and VP-Finance would "spend the time going through those journal entry binders and reviewing them" as "part of the close process," "in conjunction with the financial statements." Ex. D-4 at 45. But the only basis she could identify for this understanding was that VP-Finance and possibly also Senior Accountant told the audit team that President/CEO "was involved in the process." *Id.* at 45-51. Audit Manager stated, "I would have no way of knowing if [he] reviewed all of [the journal entries]" because "[w]e test on a sample basis." *Id.* at 47. She could not recall "any specific ones that I see or saw [him] signing off on," any specific conversation with him on the subject, or making any attempt to verify whether he reviewed any journal entries. *Id.* at 47-48, 51. Nor was she aware of any documentation of his review of the financial statements. Exs. R-509 at 79 (anything she knew about this was "through discussions"). She understood he reviewed VP-Finance's reconciliation of accounts to the financial statements simply because VP-Finance told her so. Ex. D-4 at 70-72.

As described, the audit approach relied heavily on representations from Koss personnel, coupled with broad, general references to asserted indirect support. *See, e.g.,* Exs. D-4 at 51 ("Based on the documentation and everything else that we saw in the files as it relates to auditing all of these other areas and looking at adjustments, we had no reason to believe it was anything other than what was being represented to us."), 88 ("there was no indications that we weren't provided with everything and that that was our conclusion, and we were ready to move on") & R-509 at 79-80 ("All the audit procedures that are pulled together to support our opinion and address the risks in total."), 131-32 ("everything from looking at reconciliations from looking at the variance analysis, absent exceptions in any of these other areas, we completed our testing…the testing that we had done across these areas, understanding the procedures, understanding that we saw these entries, nothing unusual coming through, we looked at the support, we saw the reconciliations and the activities going through every other area, and absent exceptions, our testing was complete").[11/]

[11/] Two further memoranda prepared each year by a junior audit team member, dated between late April and early June, made some mention of journal entries. *See* Exs. R-202 at 3-4, R-295 at 3, R-393 at 3-4 (audit plan each year, cross-referencing memoranda). The first of these two memoranda, which documented a discussion with VP of Finance and Senior Accountant about Koss's "Revenue Procedures," stated generally, "Limits of authority are established as the system will only allow authorized users to make journal entries. Access is limited by the use of user ID's and passwords," as well as "[VP of Finance and President/CEO] compare actual financial results to expected results." Exs. J-6 at 5, 7, 9 (2006; initialed by Koeppel), J-103 at 4, 7 (2007), J-203 at 4, 7, 8 (2008; initialed by Koeppel). The second memorandum purported to

Additionally, a work paper in each audit summarized a junior audit team member's early June or mid-July "walkthrough" of various aspects of Koss's processing of transactions, to determine whether key activities-level controls over critical cycles were implemented. Tr. 1238, 1292-93 (Koeppel); Tr. 289 (2006-2008 Staff/In-Charge Auditor); Exs. R-202 at 4, R-295 at 3, R-393 at 4 (audit plans for 2006, 2007, 2008). The 2006 work paper referred to several journal entries related to the processing of "1 invoice from an A/R register within the fiscal 2006 period (February 2006)" and of "1 PO from an receipts register within the fiscal 2006 period (February 2006)"—the revenue and inventory purchasing transactions selected for review in the walkthrough—but did not discuss journal entry processes, other than to state generally, "A system log-on and password are necessary to access the [IT] system." Ex. J-49 at 1, 4-5, 8 (indicating work paper not reviewed by either Koeppel or Audit Manager). And the audit team member who prepared the work paper acknowledged at the hearing that, as she had documented them, "those journal entries [related to the invoice] don't make much sense to an accountant" and were "kind of misleading," ascribing the problem to "probably a poor typing by myself" and stating, "I probably should have described better each journal entry and then saying what I could tie each to." Tr. 112-22 (2006-2008 Staff/In-Charge Auditor: "you normally don't debit AR and credit inventory," rather than crediting sales, or debit cost of goods sold and credit sales, rather than crediting inventory).

According to the 2007 walkthrough work paper, "GT observed [Senior Accountant and Junior Accountant] access the system by use of user names and passwords, noting that they have authority to post journal entries in g/l." Ex. R-300 at 6; *see id.* at 18 (based on "observ[ing] past adjustments made," "noting [Senior Accountant] is the only person who is authorized to make manual entries to the [doubtful accounts] allowance"); Tr. 287 (2006-2008 Staff/In-Charge Auditor: "the AS 400 system had some security in place that would require passwords for individuals, and it was able to break out into different sections so that some people were only allowed to import vendor master files, whereas others could record sales, for example"). The work paper further asserted that Senior Accountant and Junior Accountant "are the

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"outline the conversation held with [VP of Finance], covering the overall governance controls in place at Koss." Exs. R-205 at 1 (2006; initialed by Koeppel), R-299 at 1 (2007); *see* R-396 at 1 (2008; initialed by Koeppel). It contained general statements that "[VP of Finance] and [President/CEO] monitor the financial reporting process and are aware [of] activities throughout the organization."; "The management of the Company is highly involved in the day-to-day operations of the organization."; "Management is on-site and monitors the performance of internal controls on a regular basis."; "Management does conduct reviews of the data to ensure that the information they have received and are relying upon has integrity." Exs. R-205 at 2-4, R-299 at 1-4, R-396 at 1, 3-4. But the only specific reference to journal entries was that "[p]ersonnel are required to document the performance of key controls, e.g., monthly journal entry completion and supporting documentation." Exs. R-205 at 4, R-299 at 3-4, R-396 at 3.

only employees that have authority to record journal entries in the system" and that VP-Finance "reviews all entries," attributing these statements to interviews with Junior Accountant and/or Senior Accountant. Ex. R-300 at 1, 2, 6. It also stated, based on interviewing VP-Finance, that she and President/CEO "review monthly F/S." *Id.* at 1.

The 2008 walkthrough work paper stated that "GT viewed as [an individual identified as "Accounts Payable Staff"] entered her username and password to access AS 400, whereupon she did not have the authority to create and/or post journal entries," but Junior Accountant "did have such access." Ex. R-398 at 1, 2, 10-13; Ex. J-202 at 5; Tr. 291-93. It also referred to examination of two records that were consistent with the description the auditors were given of the roles of VP-Finance and Senior Accountant regarding journal entries. Ex. R-398 at 1 ("noting a stamp and [Senior Accountant's] initials" on a journal entry adjusting the inventory impairment reserve), 17 (referring to interview with VP-Finance and to "signature on JE" as "evidenc[ing]" "manual authorization of journal entries" for "6/30 [doubtful accounts] Allowance Calculation").

Turning to what Koeppel has described as journal entry control testing, part of those procedures in 2006 was to "[o]btain the list of individuals who initiate, authorize and record journal entries" and "evaluate the appropriateness of the individuals on this list." Ex. J-7 (2006 Test of Journal Entry Controls audit program). According to a notation on this work paper, reviewed by Koeppel, the three accounting department members "appear appropriate as only a limited number of people have access and these individuals have adequate knowledge to be posting entries." *Id.*; Ex. J-9 (sign-off page); *see* Tr. 1145 (Koeppel). It went on, "GT notes that these individuals do prepare reconciliations of the accounts that they post entries to," but responded to this concern by citing VP-Finance's assertion that "she reviews all account reconciliations and the journal entries must be authorized by [her] as well." Ex. J-7; *see* Tr. 1145-47, 1150.[12/]

[12/] Work papers reviewed by Koeppel in the 2006, 2007, and 2008 Koss audits stated that "[b]ank statements are reconciled on a monthly basis by" VP-Finance, who approved the related journal entries, had access to, and could sign Koss checks, approved credit memos and inventory adjustments, and was responsible for any write-offs of Koss accounts receivable. *See, e.g.*, Exs. J-5 at 5, 7, 13, J-202 at 6-8 (2006, 2008 Inventory Expenditures Process Memorandum); Exs. J-6 at 6, 7, 9, J-203 at 5, 6, 8 (2006, 2008 Revenue Procedures Memorandum); Ex. R-300 at 8, 21, 29, 33 (2007 Walkthrough Test Summary Report); *see* Tr. 1474-76 (Koeppel); Exs. D-4 at 61-65, 69-72 & R-509 at 57-59 (Audit Manager's investigative testimony). Such work papers additionally stated that Senior Accountant, with review by VP of Finance, reconciled Koss's sales and its accounts payable to the general ledger; evaluated any accounts that needed to be specifically reserved for; opened new customer accounts; received check copies and deposit slips from Koss's bank and entered them into the computer system; received, and kept a manual log of, direct cash payments to Koss; was involved by 2008 in the bank reconciliation process; oversaw the reconciliation of accounts receivable accounts on a daily and monthly basis; compiled the financial statements;

While this audit program directed, "Verify the completeness and accuracy of the list [of individuals who initiate, authorize and record journal entries] by comparing it to the system settings," the notation under that work step, also reviewed by Koeppel, merely stated, without explanation, "IT provided a list of all user profiles. The user profile of 'Accounting' indicates the ability to post entries to the general ledger. Per review of the listing only [Senior Accountant and Junior Accountant] have this user profile." Ex. J-7; Ex. J-73; *see* Tr. 826, 1142-44, 1148-49. Audit Manager testified in the investigation that the purpose of this procedure was "to validate the discussion we had had that only [those two individuals] had access to post entries." Ex. R-509 at 96-99, 112. Under the further work step, "Determine how often the list of individuals authorized to access the application is reviewed and by who," a notation stated, "[Per discussion with VP-Finance], as the list of individuals is so small and due to the fact that [she] reviews each journal entry that is posted, no review is done of the list of authorized individuals. GT concurs that this is reasonable for a company of this size." Ex. J-7. Audit Manager could remember no audit consideration of the outside IT contractor's expertise or audit procedures performed to test the list's completeness or consideration of what information the contractor used to generate the list. Ex. R-509 at 109-12.

While acknowledging that it "would be important to know" whether the user profile list was for the entire period of fiscal year 2006 or only a point in time, Audit Manager could not tell this from the work paper and could not recall. Instead, she stated, "One of the things we inquire about throughout the audit is understanding changes in controls and processes, so in that section, when we're obtaining the understanding, any changes, asking about control changes throughout the period, would have been noted there." Ex. R-509 at 97, 98-99 (investigative testimony). According to Audit Manager, "inquiry, observation, and the lack of exceptions noted in our sample testing" of journal entries were the procedures performed in the 2006 audit to verify that access to post journal entries did not change over the fiscal year, yet she could not recall any

had access to Koss checks; and was authorized to process Koss wire transfers, as well as posting journal entries and compiling and maintaining binders of Koss's journal entries. Exs. J-5 at 5-6, 9, 13, J-202 at 6, 8; Exs. J-6 at 5-6, 7, 9, J-203 at 4-6, 7, 8; Exs. R-300 at 6, 7, 8, 28-30, 33, R-398 at 11-13; *see* Tr. 1475; Tr. 654, 699-703 (2007-2008 Staff Auditor); Exs. D-4 at 67 & R-509 at 60-61, 164-66. The auditors did not test management representations about who had check-signing authority at Koss and how it was being exercised or gain an understanding of Koss's wire transfer procedures, beyond stating in 2007 and 2008 walkthrough workpapers, based on discussion with Senior Accountant or Junior Accountant, that wire transfers were not "integrated into the AS400 software," VP-Finance approved them, and afterward "a copy of approved wire transfer form is given to [an individual identified as "Accounts Payable Staff"] to update in AP subledger." *See, e.g.*, Tr. 1475-76; Exs. D-4 at 64, 66-67 & Ex. R-509 at 60; Exs. R-300 at 7, 8, R-398 at 12-14; Exs. J-5 at 4, J-102 at 5, J-202 at 5.

conversation about inquiry into VP-Finance’s access, nor locate any work step about evaluating VP-Finance’s access, in that regard. *Id.* at 99-100, 101-06.

When asked if any procedures were performed in the audit to verify the information provided on the user profile list, Audit Manager answered that “the level of testing that was done was a review of that listing,” which, she said, without remembering the details, was obtained by the audit team from Koss’s “third-party [IT] consultant,” an “independent source”; that it was “a very short list of individuals, all of which were easily identifiable and known to the audit team,” though she did not gain an understanding of all of the user profiles that existed at the time in Koss’s IT system, including whether anyone at the company had a “super user profile”; and that “[t]he testing that we did was to look at the underlying journal entries and saw no exceptions and had no reason to believe anything further,” referring in part to so-called “upstream and downstream testing” that used two sets of paper records to “make sure we were looking at everything for the journal entries” and “found [no] exceptions to our understanding, and, as such, did not perform any further verification.” *Id.* at 99-102, 105-13. Audit Manager’s investigative testimony was emphatic that “we did not test the operating effectiveness of the[] controls” over access of Koss personnel to post journal entries and that she believed Koeppel understood this. Ex. D-4 at 53-57.

Although at times Koeppel has referred generally to “[a]ccess controls” as part of the journal entry control “testing” in the audits (Tr. 826, 1493), the work papers for the 2007 and 2008 audits do not refer to obtaining, let alone testing, a user profile list. *E.g.*, Tr. 1143 (Koeppel: “In 2006, we had a separate program entitled Journal Entry Control Testing, where we performed steps related to access and segregation of duties.”), 1306 (“Particularly in 2006, we looked at access. We got information from the IT department as to who had access to actually make journal entries within the system.”); Ex. R-509 at 141 (when questioned in investigation about post-2006 audits, Audit Manager referred back to “those IT profile lists [obtained in] the prior year,” meaning 2006).

Rather, as Koeppel stated in other, more particular testimony, the auditors proceeded in those “subsequent years” “based on our understanding of the process, based on our understanding that there had been no changes in the process,” based on “validat[ing] that through testing segregation of duties,” and based on the view that “the walk-throughs showed that there were appropriate access controls, there were appropriate segregation of duties, and there was appropriate monitoring of people’s work.” Tr. 1300-01, 1306, 1342, 1345; *see* Ex. D-4 at 55-57 (Audit Manager’s investigative testimony: “We would perform walk-throughs over specific critical areas, and to the extent that those walk-throughs would have corroborated any [IT system access] controls,...the steps that are tailored [in the audit program are] to obtain an understanding of those controls, not to test operating effectiveness of controls….I believe so [that this reflected Koeppel’s view as well].”).

The audit plan for those latter years, like 2006, contained the general work step, "Determine whether the IT Profile in [audit documentation of Koss's internal controls carried over from the prior audit] reflects the current IT environment." Exs. R-202 at 2, R-295 at 2, R-393 at 2. Only in 2006 was an entry inserted underneath this work step to explain what work was done: "[Per discussion with VP-Finance], the IT environment has not changed at all in the past few years. As such, the IT documentation from fis[c]al 2004 is still accurate." Ex. R-202 at 2. The work papers for the 2007 and 2008 audits each included an "IT Profile Report," initialed by Koeppel. The document was a two-page, high-level summary list of technologies used by Koss for certain general business functions, under the categories "Computer Systems," "Applications / Spreadsheets," and "Transaction Processing." Exs. R-297, R-395. But no mention was made there of user access controls. *See generally* Tr. 222-23, 233 (2006-2008 Staff/In-Charge Auditor inquired generally of Koss's outside IT consultant "one of the years about updating just to get his general information on the systems in place, if they had changed, any improvements they put in place" and in 2008 inquired primarily of Junior Accountant).

As noted, testing of journal entry controls in the 2006, 2007, and 2008 audits also included review of paper records of Koss journal entries. The 2006 journal entry review memorandum expressed the understanding, based on a discussion with VP-Finance, that "Koss has standard journal entries that are entered every month," that a "journal entry log is maintained with the standard journal entry numbers," and that "[t]here are also non-standard journal entries [which] are identified by a non-standard journal entry number," *e.g.*, "a standard journal entry number is 600, which is on the journal entry log" and a "non-standard journal entry number would be 600A." Ex. J-11 at 1.

Elaborating on that understanding, the 2006 journal entry testing work paper stated that: "All journal entries are accumulated in monthly binders. At the front of each binder there is a checklist of numbered standard/recurring entries. As the entries are made they are checked off of the list. This list is also reviewed and initialed by [VP-Finance]." Ex. J-10 at 2; *see* Tr. 790-92 (Koeppel); Tr. 213 (2006-2008 Staff/In-Charge Auditor). According to testimony, if one of the numbers in the sequence on the log or checklist were not used that month, this would be "indicated with a slash or a zero on that line," and the numbers of the nonstandard journal entries posted to Koss's general ledger that month were handwritten at the bottom of the list. Tr. 71, 72-73, 87, 89. Each year, VP-Finance told the auditors that "not all entries [in the binders] have support attached to the journal entry due to the fact that many entries are recorded based on large system reports." Exs. J-10 at 2, J-105 at 2, R-452 at 1, R-465 at 1 (work papers); *see* Ex. J-205 at 1 ("not all entries have support in the binder as some entries are calculated based on large system-generated report"); Ex. J-11 at 1, 3, 5 (examination of binders showed "some entries had support and others didn't" and "not all standard journal entries had support behind them"); Tr. 51-52, 252-53 ("for example, when they posted, like AP from the subledger to the [general] ledger," an automated process with a system-generated entry, "they didn't print off the entire ledger, they only printed off, maybe, the last page," so "there wasn't always really detailed support") (2006-2008 Staff/In-Charge Auditor).

For standard entries, Koss reserved ranges of up to 100 numbers for journal entries in each of seven subject matter areas (such as revenue or inventory), from 001-099 to 600-699, and did not exhaust all of the available numbers within each range, leaving gaps. Tr. 74-77, 83, 87-90. Nonstandard entries did not follow a numerical sequence, utilizing as many letters as "they would need" added to one or another standard journal entry number, and the amount of nonstandard entries could vary from month to month, depending on "whatever they need to do for that month." Tr. 72-73, 85-86; *see* Tr. 550 (use of letter suffixes). Although the 2007 and 2008 walk-through work papers stated the audit team understood that Koss's IT system did not allow the creation of duplicate vendor, customer, inventory, invoice, credit memo, or warranty claim numbers (Exs. R-300 at 4, 5, 10, 16, 19, 22, 31, R-398 at 3, 4, 10, 15, 18, 20; Tr. 293), there is no evidence that this was true of journal entry numbers (*see, e.g.*, Ex. R-509 at 86, 92-94 (testifying in investigation, Audit Manager acknowledged that it would be a matter of concern if Koss's IT system allowed duplicate entries to be posted with the same journal entry number but stating that she could not recall whether it did)).

In 2006 and 2007, as part of the fiscal year-end audit work, "GT haphazardly selected 30 journal entries" that it understood to have been entered in Koss's general ledger over the course of the fiscal year, and in 2008, "haphazardly selected 10 journal entries" each quarter, "to test to ensure that only authorized individuals post and review all non-system generated entries." Exs. J-10 at 1, J-105 at 1, J-205 at 1, R-452 at 1, R-465 at 1; *see* Exs. J-7, J-104, J-204 (audit programs); Tr. 57-59, 62-63; Ex R-509 at 115, 121 (the testing sample included both standard and nonstandard manual journal entries). The work papers for the testing stated that journal entry forms were "written out and initialed" by the person initiating and posting the entry, were reviewed by VP-Finance, and, after being entered into Koss's IT system, were placed in the monthly form binders, which, according to testimony, were maintained by Senior Accountant, were stored on a bookshelf in her open and accessible office, and were provided to the auditors. Exs. J-10 at 2, J-105 at 2, J-205 at 1, R-452 at 1, R-465 at 1 (work papers); Tr. 47, 49, 50-51 & Ex. J-303 at 1 (example of completed journal entry form, stamped "Entered," above Senior Accountant's initials, and initialed in upper corner by VP-Finance); Tr. 785-87, 790-92, 813-14, 818, 822, 824-25, 834-45 (Koeppel); Tr. 46-50, 51, 57-59, 88, 342-44 (2006-2008 Staff/In-Charge Auditor); Tr. 426 (2007-2008 Staff/In-Charge Auditor); Tr. 548-49, 561-62, 657-60, 705 (2007-2008 Staff Auditor); Exs. D-4 at 83 & R-509 at 84, 88, 145, 146-47 (Audit Manager's investigative testimony).

Based on a junior audit team member's examination of the manually completed forms for the journal entries selected for testing, the work papers identified either Senior Accountant or Junior Accountant as the person who initiated and posted, and VP-Finance as the person who approved, each of those entries. Exs. J-10 at 1-2, J-105 at 1-2, J-205 at 1-2, R-452 at 1, R-465 at 1; *see* Tr. 1311 (Koeppel testified that she never saw a journal entry posted by VP-Finance); Tr. 337-38 (2006-2008 Staff/In-Charge Auditor: did not see any entry that conflicted with the understanding reflected in the audit work papers). Consistent with the other years, a 2008 work paper noted that "[t]his is not a completeness test" but "simply a review of" journal entries "for reasonableness and proper approval." Ex. R-452 at 1 (stating conclusion that "[p]er testing performed, GT deems JEs to be reasonable at 12/31/2007"); *see* Ex. J-10 at 2 (2006: "Per the above testing the controls over journal entry process appears to be working effectively."); Ex. J-105 at 1-3 (2007: "Per testing performed, GT deems JE to be reasonable at 6/30/07," "[b]ased on review" of support in the journal entry binder and "based on knowledge of business operations"); Ex. J-205 at 1 (same for 2008; "this is not a test of the completeness of the detail provided to GT").[13/]

A junior audit team member testified, without being able to find express support for it in the audit documentation, to keeping Koss's "standard method of numbering" in mind when consulting the checklist pages and "flip[ing] through all of the binders" of paper records as part of the journal entry audit work (Tr. 70-74, 80-81, 87-88, 91-92), but Koeppel recognized this was not a viable means of determining the completeness of the binders because it "was not the case" at Koss that "all entries were numbered sequentially" (Tr. 1322-23). Indeed, this was apparent from the junior auditor's own testimony. *See, e.g.*, Tr. 71-77, 83, 85-86, 91 (2006-2008 Staff/In-Charge Auditor).

[13/] The 2006 journal entry review memorandum described certain additional audit work on the entries that appeared in the monthly form binders, stating that "GT": (1) "reviewed all non-standard journal entries and inquired about non-standard journal entries that appeared unusual or were over" 10% of tolerable error of $330,000, noting that in some cases "support was attached [to the manual journal entry form] to show how the entry was derived" and "[e]xamin[ing] [any] underlying support for all entries identified," or, for one cash-in-transit entry, "[a]gree[ing] to bank statement"; and (2) noted standard journal entries for May, June, and July 2006 that "appeared unusual" or were above tolerable error, noted whether all entries identified were included on the standard journal entry listing and generally whether "the descriptions on [the listing] appear reasonable," and examined support for certain May-July 2006 entries, though none existed for most over $330,000. Ex. J-11 at 1-5. The memorandum concluded, "Per the above testing, it is noted that the non-standard and journal entries appeared to [be] appropriate through GT's review of the journal entry support and GT's inquiry of the client." *Id.* at 5-6. In 2007, the following notation was made on the journal entry audit program under the work step, "Identify significant and unusual journal entries and other adjustments made at or near the end of the period": "GT reviewed all JE posted from 6/25/07 through 7/5/07, specifically noting all JE over TE of $260,000. Through review of the JE support for each of these JE, GT deems all significant JE around YE to be reasonable." Ex. J-104; Tr. 60-62, 70, 393 (2006-2008 Staff/In-Charge Auditor used Koss system-generated "update reports" to identify the journal entry forms to examine). No description of audit work was inserted under that work step in 2008. Ex. J-204.

Although the work papers are not clear on the point, Audit Manager testified in the investigation that the 30 journal entries "pulled" from the monthly form binders and examined to test Koss's journal entry controls in the 2006 audit (*see* Ex. J-10 at 2) were selected by month and number in part from the form binders and in part from another set of Koss paper records. Ex. R-509 at 122-23, 129, 133 & Ex. D-4 at 84. For the 2007 audit, the work papers state that half the journal entries used for the control testing were selected by month and number from each source. Ex. J-105 at 1. The procedure used for the 2008 fiscal year varied by quarter as to whether all or only half the journal entries used for control testing were selected from the monthly form binders, and five extra entries, beyond the 40, were selected from the other source for additional fiscal year-end audit testing. Exs. J-205 at 1-4, R-452 at 1-2, R-465 at 1, 3; Tr. 343.

Koeppel testified that during these years she understood the audit team traced journal entries selected from the binder of journal entry forms to the binder of update reports, and vice versa, as a test of the completeness of the journal entry population provided by Koss's accounting department. *E.g.*, Tr. 822-23 (Koeppel); *see, e.g.,* Ex. R-509 at 111, 122 (Audit Manager's investigative testimony); Ex. R-452 at 1 (2008: "GT tests completeness of journal entries as part of the year-end audit"). This procedure was referred to in testimony as "upstream/downstream" testing. *E.g.*, Tr. 770-71, 828, 835-37, 1185-86, 1327-29 (Koeppel); Tr. 54, 70, 341-42, 411-12 (2006-2008 Staff/In-Charge Auditor); Ex. D-4 at 81, 84-86 & Ex. R-509 at 110, 130. Koeppel understood that no attempt was made as part of this testing in the 2006, 2007, and 2008 audits to trace paper records of Koss's journal entries to its electronic general ledger. Tr. 770-71, 792, 818-19, 822-23, 1329; *see, e.g.,* Tr. 103-05, 414, 432; Tr. 559, 705-06. Nor, Audit Manager stated, were alternative procedures performed to test the completeness of the journal entries in the binders such as to reconcile the beginning and ending account balance for any general ledger account using the so-called update reports (discussed below) for the fiscal year, which purportedly were generated by Koss's IT system when journal entries were posted. Exs. D-4 at 127 & R-509 at 127-28, 179 (investigative testimony). Even so, as Audit Manager explained, "it's important to do some testing to see that the population you were given was complete" because "[w]hen evaluating whether or not you're looking for things that are unusual in nature and nonstandard, you can't evaluate what's not there"; "you can only evaluate what you're seeing, and if it's not there, you can't appropriately evaluate." Exs. D-4 at 82-83 & R-509 at 94.

Specifically, as a work paper related, VP-Finance said "the G/L system does not allow Koss to print out [a] listing of journal entries recorded during the year" but "noted that each time a journal entry is recorded, an 'update report' is automatically generated by the system, which confirms that the entry hit the G/L. Therefore, because there is no system generated JE listing, GT used the 'update reports' to perform the completeness test." Ex. J-205 at 3 (2008); *see* Exs. J-10 at 2 (2006), J-105 at 2 (2007), R-452 at 1 (2008), R-465 at 1 (2008); Tr. 787-89, 835-37, 1491 (Koeppel); Tr. 53, 90-92, 102-03, 106, 110-12 (2006-2008 Staff/In-Charge Auditor); Tr. 424-26 (2007-2008 Staff/In-Charge Auditor); Tr. 552-55 (2007-2008 Staff Auditor); Ex. R-509 at 129, 132. Audit team members testified they understood the so-called update reports represented all the journal entries posted to Koss's general ledger. *See, e.g.*, Tr. 431-32 (2007-2008 Staff/In-Charge Auditor: for 2008 testing, "I sat down with" Senior Accountant at her "computer screen, and I just asked her to kind of walk me through the whole process of how these update reports get generated" and "my takeaway from that conversation was that…the update reports were reflective of what was in the general ledgers"); Tr. 559, 705-06 (2007-2008 Staff Auditor understood, "[e]ither from Koss management or from the [audit] team," that the update reports provided complete population of journal entries); Ex. R-509 at 129, 132 (Audit Manager's investigative testimony: audit team believed "the accumulation of all of those update reports did reflect the GL").

Senior Accountant compiled the update reports, organized by month, and stored them in binders on a bookshelf in her office, and VP-Finance or, in part of 2007 and in 2008 Senior Accountant, made them available to the auditors. Ex. J-10 at 2 (2006); Exs. J-105 at 2, R-452 at 1, R-465 at 1 (2007); Ex. J-205 at 1 (2008); Tr. 770-71, 787-89, 822 (Koeppel); Tr. 52, 53-54, 102, 334-35; Tr. 555 (update reports kept in common area in accounting department); Ex. R-509 at 87-88 (maintained by "the accounting group," which "offices are open, so they're accessible"). Koss's outside IT contractor had no involvement in preparing or maintaining the monthly binders of journal entry forms or the monthly binders of update reports. Tr. 99-100, 334-35. Nor was there audit testing of any controls over the preparation of either set of journal entry binders or over the generation of the update reports. *See, e.g.*, Tr. 827, 1473 (Koeppel).

According to an audit team member, the update reports were produced on "green bar" paper from "an old school printer" at Koss, "weren't printed out together for an entire quarter or period," and, depending on how many journal entries a report included, it would be "wrapped, so it would be like one big sheet, and they just folded it," not "ripped apart." Tr. 412-13, 417 (2006-2008 Staff/In-Charge Auditor); *see* Ex. R-509 at 88 (Audit Manager's investigative testimony: Koss "printed just about everything on large green bar" paper). An update report could reflect a single journal entry or it could reflect a batch of journal entries posted to the IT system at one time. Tr. 770-71, 788-89 (Koeppel testified that she understood that Koss's IT system printed a separate update report each time journal entries were recorded and that a member of the accounting department manually compiled the individual reports into a set); Tr. 555-56 (2007-2008 Staff Auditor: there could be a single entry on an update report and then the next time a journal entry or entries were posted, the new entry or entries would be reflected on a new and separate update report, not physically connected to any other); Tr. 52-53, 90, 412-13 ("they often posted a lot of journal entries together, so you could see that there were usually a lot around month end" and "you had a little more comfort in that [such entries] were in big batches," with a "bunch of them together" in one report); Ex. R-509 at 118-20, 129 (stating that update reports were "a series" of individual reports and, although "the majority of [journal entries] were done at month-end," Koss "did have the ability to post things throughout the month"). Thus, it was not evident from looking at the update reports provided by Koss's accounting department whether reports relating to certain entries had been removed from the binders. Tr. 557, 705-06.

For the 2006 audit, a junior audit team member "agreed" by "Month" and "Journal Entry #" 24 of the 30 journal entries used in the journal entry control testing both "to written journal entry in monthly je binder" and "to 'Journal Entry Detail Update' report," viewed as "a system print out of all journal entries recorded during the year." Ex. J-10 at 2 (work paper); *see* Tr. 789 (reference in work paper to a "binder with a system print out of all journal entries recorded during the year" simply meant a binder of the Koss accounting department's manual compilation of multiple individual update reports), 792-94, 817, 822-23 (Koeppel).[14/] Additionally, "to test the accuracy of the checklist [at the front of each monthly binder of manually completed journal entry forms], each month GT selected 2 standard entries from the checklist and verified that entry was included in the binder. No differences were noted. As such, GT is reasonably comfortable that we were provided with the entire population of entries." Ex. J-10 at 2.

The 2007 work paper stated, "In order to test for both completeness and exist[e]nce/occurrence GT made half of the selections [of 30 journal entries] from the listing [*i.e.*, the update reports] and half of the selections from the monthly JE [form] binders." Ex. J-105 at 1. It documented that these entries were agreed, by month and journal entry number, to the update report and the manual forms. Ex. J-105 at 1, 3; *see* Tr. 815-19, 822-23 (Koeppel); Tr. 63-70, 337-38 (2006-2008 Staff/In-Charge Auditor).

In 2008, according to the audit documentation in the record, the auditors "[a]greed [ten journal entries, by number and date, from July 2007 to May 2008, selected from the update reports] to written journal entry in monthly JE binder" and "[a]greed [nine journal entries, by number and date, from July 2007 to May 2008, selected from the 40 entries from the binders of manually completed forms used in the other 2008 journal entry testing] to 'Journal Entry Detail Update' report." Exs. J-205 at

[14/] Notations in the "Initiated & Posted By" and the "Approved By" columns of the work paper were agreed only to the respective manual journal entry form, not to an update report. Ex. J-10 at 1-3. At the hearing, an audit team member who performed Koss journal entry testing during the relevant period identified two one-page examples of update reports generated by Koss's IT system, neither of which showed who initiated, posted, or approved the journal entry (Ex. J-303 at 2, 3). Tr. 54-56 (2006-2008 Staff/In-Charge Auditor explaining that first example was report printed in response to posting of manual journal entry reversing entry to accrue accounts payable). In the investigation, Audit Manager also testified that Koss's update reports did not identify who approved a journal entry, and although she suggested she recalled that the update reports did show who initiated and posted an entry, she acknowledged she did not perform the journal entry testing in the 2006, 2007, or 2008 Koss audits. Ex. D-4 at 82 & Ex. R-509 at 117, 131, 149. There is no claim or evidence that Koss's IT system required an electronic approval to post a journal entry to the general ledger. *See, e.g., id.* at 117-18, 142.

1-4, R-465 at 1, 3; Tr. 832-38 (Koeppel); Tr. 341-42; Tr. 427-432; Tr. 546-47, 551-54, 557-60, 562-63; Ex. 509 at 145-46, 147-49 (Audit Manager's investigative testimony). The stated conclusion was, "Based on the above testing, GT concludes that it appears the population we selected for our <JE testing> was complete." Ex. J-205 at 3, 4.

Koeppel has acknowledged that the "upstream/downstream" testing in the 2006, 2007, and 2008 Koss audits, which compared two sets of paper journal entry records with each other, would not identify any journal entry missing from both sets. Tr. 795, 837-38, 1151-53, 1493; *see* Tr. 106-10 (2006-2008 Staff/In-Charge Auditor); Tr. 705-06 (2007-2008 Staff Auditor). No work step in any of those audits specifically addressed that issue. *See* Tr. 825-29, 1142, 1451 (Koeppel); Tr. 560 (2007-2008 Staff Auditor); Ex. D-4 at 84-88 & Ex. R-509 at 127-28 (Audit Manager's investigative testimony: "it was not a specific risk that was added or specifically tested for"). The audit work on access controls over Koss's IT system did not do so. Tr. 827, 1149. Nor did the audit determination that segregation of duties actually existed within Koss's accounting department, which relied on being able to test a sample from the whole population of journal entries. *See* Tr. 1306, 1311 (Koeppel); Tr. 706-07 (2007-2008 Staff Auditor).

Nor did what Koeppel characterized as "journal entry testing in the walk-throughs" (Tr. 825; *see* Tr. 860-61, 1292), which consisted of viewing a small number of isolated entries as part of gaining "a basic understanding" of Koss's "overall control structure" and "validating our understanding of [certain] process[es]" and key internal controls in place, with no cross-reference to or from the purportedly systematic journal entry testing (Ex. D-4 at 32-33, 65 (Audit Manager's investigative testimony)). *See* Exs. J-49 at 1, 4 (2006), R-300 at 1, 18 (2007), R-398 at 1, 17 (2008); Tr. 1287-88 (Koeppel); Tr. 105 (in one-off situation where had specific inquiry and Senior Accountant "used the system to help me understand things,…I wasn't doing it, I guess, for the specific [journal entry] test"), 414 ("go[ing] to the computers" and having Koss accounting staff "show me things and explain things" was not "journal entry testing specifically") (2006-2008 Staff/In-Charge Auditor); *see also* Tr. 523 (2007-2008 Staff/In-Charge Auditor: referring to "actually sitting at the client's computer screen, seeing how transactions kind of flow through these systems" to gain "understanding of how the control structure worked"). And there is no evidence in any of those audits of specific testing of the operating effectiveness of controls over the production of the update reports, to determine whether Koss's IT system generated a report every time a single journal entry or batch of entries was posted to the general ledger, or of controls over the creation and maintenance of the sets of paper records. *E.g.*, Tr. 825-29, 1473 (Koeppel). Nor was any effort made in the audits to take all of the update reports for any fiscal year and use them to reconcile the beginning and ending balance for any particular general ledger account. Ex. D-4 at 127 & Ex. R-509 at 179 (Audit Manager's investigative testimony).

Beyond the foregoing, the journal entry audit work also included "[i]nquir[ing] of individuals involved in the financial reporting process if they were requested to make unusual entries during the period or if there is a possibility of accounting misstatements resulting from adjusting or other entries." Ex. J-11 at 4 (2006); *see* Exs. J-104 (2007), J-204 (2008); Tr. 1198, 1270 (Koeppel); *see generally* AU § 316.58d. According to the testimony in the case, these audit inquiries were made of each of the three accounting department members individually, in separate in-person meetings with each. Tr. 1198 (Koeppel); Tr. 339 (2006-2008 Staff/In-Charge Auditor); Tr. 661-62, 707-08 (2007-2008 Staff Auditor); Ex. R-509 at 50-54 (Audit Manager's investigative testimony).

In 2006, the work papers stated that, per discussion with VP-Finance, Senior Accountant, and Junior Accountant, "none of them has been requested to make unusual entries, is suspicious of fraud, or is aware of anything out of the ordinary as it relates to management." Ex. J-16 at 4; *see* Ex. J-11 at 4. In 2007, the work papers gave the same account: "PDW [Senior Accountant] and [Junior Accountant] they were not requested to make any unusual entries during the current year." Furthermore, based upon discussion with Senior Accountant, "the majority of journal entries posted are standard entries," which "are usually system generated," so "she feels that there is minimal risk of an accounting misstatement"; "both she and [Junior Accountant] have been with Koss for a number of years and are very familiar with the business"; and VP-Finance "rev[ie]ws all standard and non-standard JE," which "further mitigates the possibility of accounting misstatements." Ex. J-104; *see* Tr. 338-40, 394-95.

Similarly, the 2008 work papers documented, "GT inquired of [Senior Accountant and Junior Accountant] as to whether either has been asked to make unusual entries during the period, noting both negatively responded. Through journal entry testing performed at the quarterly reviews and at year-end, GT notes no entries initiated by an individual other than [these two persons]." In addition, "PDW [Senior Accountant and Junior Accountant], the risk of accounting misstatement resulting from adjusting or other entries made during the period is minimal. GT notes [these two persons] have been employed in their current roles for several years and are therefore very familiar with the Company's operations, thereby further mitigating the risk of unintentional misstatement." Ex. J-204; *see* Tr. 661-62, 710 (2007-2008 Staff Auditor).

Finally, Koeppel notes that each year President/CEO and VP-Finance stated in a letter to Grant Thornton on or around the date on which the financial statements for the fiscal year under audit were filed with the SEC that, among other things, all "[f]inancial records and related data" have been "made available to you"; there are "no material transactions that have not been properly recorded in the accounting records underlying the financial statements"; and "[w]e have no knowledge of fraud or suspected fraud affecting the Company involving" management, employees who have significant roles in internal control, or others where the fraud could have a material effect on the financial statements. *See* Exs. J-67 at 2-3, J-182 at 1-2, J-280 at 1-2; Tr. 1232-36 (Koeppel).

2. Revenue-related accounts

Koeppel testified that the approach to testing revenue that she used in leading the 2006, 2007, and 2008 Koss audits was, “We focused on tests of details of the balance sheet and analytics as it relates to the income statement.” Tr. 1353. She stated she was familiar, in general, with the revenue procedures in the audits. Tr. 1430.

a. Net sales

Koeppel testified that she planned in each audit for the use of analytical procedures as substantive tests of the occurrence and valuation of the net sales Koss reported on its income statement. Tr. 871, 875, 938-39, 944-46, 955, 992-93, 1002, 1009, 1022, 1078, 1369-70, 1435-36; *see, e.g.,* OIP 14 ¶ 43; Ans. 21 ¶ 43; Tr. 689 (2007-2008 Staff Auditor); Ex. R-509 at 74-75, 161 (Audit Manager’s investigative testimony). During her tenure on the audits, Koeppel participated in firm training related to analytical procedures and signed off on a number of work papers documenting such procedures in the audits, and she has stated she was broadly familiar at the time with the analytical procedures performed. *See, e.g.*, Tr. 1027-28, 1188, 1499; KPHS 40.

Koeppel and other audit team members have testified that the strategy and execution of the Koss audits did not include tests of details of income statement accounts, such as obtaining, reviewing, or tying to Koss’s general ledger any detail listings of the transactions in Koss’s sales accounts or reconciling those accounts with sales figures from Koss’s accounts receivable subledger or underlying invoices. Tr. 961-65, 987-90, 1010-13, 1067-68, 1081-83, 1409-11, 1488 (Koeppel); Tr. 151-52, 196, 220-21, 401 (2006-2008 Staff/In-Charge Auditor); Tr. 713-14 (2007-2008 Staff Auditor); Ex. R-509 at 150, 153, 161-62, 165-66 & Ex. D-4 at 106-108, 114-20 (Audit Manager’s investigative testimony). But, according to Koeppel, she did consider the analytical procedures on the sales accounts in conjunction with audit work on other revenue-related accounts, including tests of details of accounts receivable and sales allowances reported on Koss’s balance sheet, which we discuss later. *E.g.*, Tr. 1191, 1360. And she recognized that to address Koss’s net valuation of sales, audit work was necessary not only on Koss’s gross sales but also on the sales allowances that were subtracted from gross sales in arriving at Koss’s net sales. Tr. 964, 1014, 1082.

The Division’s expert witness identified, without contradiction, 81 separate analytical procedures, performed by the engagement teams for the audits in question or for quarterly reviews during those audit years, “that had some relationship to net sales, accounts receivable, inventory and/or the cooperative advertising and promotion allowances.” Ex. D-2 at 54; *see, e.g.,* DPHS 34-35 & n. 22 (noting that of 83 total procedures listed by the expert, two had been included in the work papers twice under different bates numbers); R.D. 88 at 42-45 (cross-referencing procedures identified by the expert to hearing exhibit numbers); KPHS 74. The expert explained that, although the work papers did not necessarily indicate which of the procedures were intended or considered to be substantive tests (*see* AU §§ 329.09-.21), he assumed for purposes of his report that all of them may have been so, as opposed to having been used only in the planning or overall review stages of the audits (*see* AU §§ 329.06-.08, .23). Ex. D-2 at 54; *see* Tr. 1023-24 (Koeppel). As noted, Koeppel testified that substantive analytical procedures were used to test net sales, and she further asserted that each year she "took all the information" from "all of our analytics," "including work on the quarters," "into consideration" as evidence to support the audit opinion she formed. Tr. 992. We evaluate the analytical procedures, whether substantive or not, for the weight they may have contributed to the audit work on the existence and valuation of Koss's revenue.

Of the 81 analytical procedures, the Division's expert witness categorized four as relating only to inventory, not also to revenue. Of the remaining 77 procedures, the Division's expert identified three as limited to sales allowances, and, because the purpose of those work papers was to test liability accounts, he viewed them as providing "little" or "minimal to no support" for net sales. Ex. D-2 at 118, 125, 130. Four other procedures used sales figures for one or two fiscal years and for June to test the reasonableness of Koss's returns reserve, all as reflected in Koss trial balance reports. *Id.* at 61, 117, 119, 125, 130; *see* Exs. J-52 at 7-9 & J-53 (2006: "obtain[ing] average return rate for the year based on yearly returns and sales figures" and "multiply[ing] the calculated return rate" by "June sales figure to estimate probable returns related to these sales"); J-152 at 12 (2007: same), J-248 at 4 (2008: same, except calculating average return rate over current and prior year). According to the Division's expert, "Because this testing was performed on the sales return liability, however, these analyses by their nature provide little support for the existence and valuation of Koss's net sales." Ex. D-2 at 61. Koeppel did not contest any of these points.

Of the remaining 70 procedures, the Division's expert categorized 45 as trend analyses and 25 as ratio analyses. Ex. D-2 at 54, 55, 58, 117-131. By these terms, according to audit guidance cited in his report, the expert meant, respectively, "'the analysis of changes in an account balance over time'" and "'the comparison of relationships between financial statement accounts (between two periods or over time).'" *See* Ex. D-2 at 49, 55, 58, citing *AICPA Audit Guide: Analytical Procedures* ¶¶ 1.24, 1.28 (New York, NY: AICPA, 2001). Koeppel's expert witness stated that 38 of these procedures were prepared for quarterly reviews. Ex. R-507 at 91; *see* Tr. 992. By our count, the number is 37: 25 trend analyses and 12 ratio analyses. Koeppel's expert explained that the quarterly review procedures "were never intended to meet the criteria for analytical procedures performed in annual audits under AU § 329." Ex. R-507 at 91; *accord* Tr. 2075-76. Furthermore, the Division's expert pointed out, without contradiction, that eight of the 13 remaining ratio analyses (two performed in the fiscal year-end audit and six prepared during the quarterly reviews, in either 2007 or 2008) calculated various expense amounts as a percentage of net sales and did not develop expectations or provide support for the net sales figure itself. Ex. D-2 at 59 (referencing Exs. J-149, J-161, J-166, J-171, J-244, J-258, J-263, J-267).

The trend analyses compared Koss's current-year sales figures with prior-year amounts, noting in six year-end procedures in 2006, nine quarterly procedures in 2007, and two year-end and four quarterly procedures in 2008 an expected increase or decrease but not defining any specific amount or percentage. Where the work papers referred to changes in Koss's operations, such as new sales contracts during the current year, the auditors simply expressed their expectations in broad terms, rather than formulating specific expectations of differences from prior-year sales amounts.

Indeed, the expectations of differences from prior-year sales amounts in these trend analyses were stated so generally that they did not capture identified changed circumstances with any meaningful level of precision that would have enabled the auditors to identify differences that might be potential material misstatements. *See, e.g.*, Exs. J-25 & J-26 at 1 ("significantly higher" sales), Tr. 135-38, 966; Ex. J-48 at 4, 8, 17 (same); Ex. J-233 at 1 (expecting "increase" in sales for third quarter 2008, "down" for the nine-month period ending with that quarter; Koss "entered into two new agreements with" two large discount retailers in "Mass" sales account) & Ex. J-266 at 1 ("Budget Variance Analysis," noting decrease in budgeted to actual third-quarter 2008 sales in "Mass" account "caused by loss of the [product] line" for one of the two retailers and a third retailer), Tr. 1049-50; Ex. J-254 at 1 ("comparable (if not reduced)"); *compare* Ex. J-144 at 2 (fiscal year-end 2007 analytical procedure stating expectation of "overall decrease" in sales while noting that "export sales continue to increase"), citing Ex. J-167 at 1 (expecting "declining trend" of sales "generally down" for third quarter 2007), *with* Ex. J-168 at 2 (third quarter 2007 analytical procedure that "noted a pull-back in 'Export' sales" for the second quarter and stated, "GT would anticipate 'Export' sales to continue on it[]s declining trend through Q3").

Further examples of such imprecise trend analyses include the following, all in work papers specifically signed off on by Koeppel: Ex. J-17 at 2, 13 (sales will be "up"); Ex. J-18 at 1, 5 (up for quarter where, to date, "sales for the year are up over last year"); Ex. J-22 at 1, 4 ("significantly higher" sales; Koss had been "securing new customer agreements"); Ex. J-23 at 1, 4 ("increase" in sales; "Koss focused on selling its products in new markets"), Tr. 938-39, 942-43, 949; Ex. J-24 at 1, 3 ("mostly higher" revenue; "new demands such as headphones in cars for cars that come with TV's" and "Koss wanted to expand the European market to help[] its product grow on a global level"), Tr. 944-46, 949; Ex. J-141 at 2, 4 ("weak," "drop," or "strong" in certain sales; one customer "suffering from the effects of a slumping auto market," "the loss of contracts" with two electronics stores, "promotional event" with third electronics store); Ex. J-147 at 1, 6 ("down," "declining trend"; a "pull back (or leveling off)" from "the tremendous sales growth Koss experienced in the prior year"); Ex. J-158 at 1, 6 ("decreased" sales; "pull back in sales was bound to occur" "eventually" "[d]ue to Koss's continued growth in sales over the past year"), cross-referenced in Ex. J-143 at 2 ("decrease"); Ex. J-162 at 2, 6 ("increased sales" over prior-year period; "the continued increase in export sales"); Ex. J-163 at 2, 5 (certain sales "increased" or "down"; "continued success of [export] market segment," "loss of the [two electronics stores] contract"); Ex. J-168 at 2, 6 (“declining trend,” “down,” “decrease” in certain sales; “pull-back in ‘Export’ sales,” “loss of contracts with” the two electronics stores, “shipped new models to [the third electronics store] in the PY”), Tr. 985-93; Ex. J-211 at 1, 22 (fourth-quarter 2008 sales expected to “slightly outpace” fourth-quarter 2007 sales, “increase”; “the addition of two new agreements” with two buyers “during Q1 [2008], which were expected to drive sales higher as these discount retailers expose their massive customer base to the family of Koss products”) & Ex. J-266 at 1 (noting decrease in budgeted to actual third-quarter 2008 sales in “Mass” account “caused by loss of the [product] line” for one of the two retailers and a third retailer), Tr. 1059-63; Ex. J-241 at 1, 3, 10 (“downward trend,” “decrease”; “Koss is coming off a period when their sales were at an all time high”); Ex. J-259 at 1-2, 6 (“comparable (if not reduced)”).

Similarly, a quarterly 2007 ratio analysis signed off on by Koeppel stated that: “GT deems [AR/sales] ratio reasonable” because a “reduction” in Koss’s sales was anticipated. Ex. J-169 at 1.[15/] At the hearing, Koeppel observed that “how we do analytics today and the amount of documentation we do as it relates to expectations is significantly more than I acknowledge what we did on Koss.” Tr. 1499; *see* Tr. 1188.

The Division’s expert identified certain trend analyses in which the expectations were potentially more precise because they had been developed “based on data disaggregated by either month, product line or both.” Ex. D-2 at 56. As Koeppel explained, “breaking [the sales data] down by more than just account level,” “mov[ing] from looking at it on account basis to quarterly, also looking at it on a monthly basis” was done in the audits “[b[ecause disaggregation is more precise.” Tr. 1382.

Specifically, each audit included two analytical procedures that compared certain Koss sales data for all and parts of the current fiscal year to the corresponding data from the prior fiscal year, using reports generated by Koss’s IT system. An analytical procedure performed in all three audits (“Variation Analysis” or “Variance Analysis”) compared total gross sales amounts for the current and the prior fiscal year for 14 “product line” categories (*i.e.*, detailed income statement sales accounts), such as “Education,” “Export,” “Mass,” “OEM,” “PX and Prison,” “Radio Shack,” “Record Music Books,” “Specialty,” “Superstores,” and “Internet/Catalog,” which accounts could include

[15/] The report of the Division’s expert witness also identified 34 revenue-related analytical procedures in which the auditors appeared to have formed the expectation that Koss’s current-year amount would be unchanged from its prior-year amount, despite changed circumstances from the one year to the next being noted in the same work papers to explain significant unexpected differences between the expectation and the recorded amount. In the expert’s view, this indicated that the changed circumstances had not been considered in forming the expectation, “undermining the precision of the expectation and the effectiveness of the analysis.” *See* Ex. D-2 at 50, 117-120, 123-131 (describing 19 trend analyses (13 fiscal year-end, 6 quarterly) and 15 ratio analyses (11 fiscal year-end, four quarterly)).

multiple customers. Exs. J-25, J-118, J-214; Tr. 142, 987, 1008-10, 1015, 1076-78. Each of these work papers referred to another work paper for a discussion of changes in the balances of those sales accounts. Exs. J-25 at 1, J-118 at 1, J-214 at 1.

In the 2006 audit, the other work paper consisted of a list of notes under a statement of “Expectations” and “Scope.” Ex. J-26 (“Variation Analysis”); Tr. 955-56. Additionally, a separate 2006 audit work paper documented a “Revenue by Month” analytical procedure comparing Koss’s total recorded net sales for each month of the current to the prior fiscal year. Ex. J-24. In the 2007 audit, the annual Variance Analysis highlighted changes from the prior year in certain of the 14 sales accounts and cited a “Monthly Sales Analysis” for “an analysis of changes in revenue,” but the cross-referenced document discussed certain year-over-year changes in aggregate monthly net sales without addressing each of the noted accounts. *See* Ex. J-115; Tr. 1001-02 (Koeppel); Tr. 200-02 (2006-2008 Staff/In-Charge Auditor). The closest the 2007 work papers came to doing so was an analysis consisting of comparisons of Koss’s gross sales for the third quarter of the current and the prior fiscal year, broken down by month and by the 14 categories, which, according to Koeppel, was consistent in methodology with the sales analyses performed as part of quarterly reviews for prior quarters in fiscal year 2007. *See* Ex. J-168 (“Sales by Month by Product Line”); Tr. 989. For 2008, the annual Variation Analysis cited a work paper consisting of comparisons of Koss’s gross sales for all quarters of the current and prior fiscal years, broken down by month and by the 14 categories. *See* Ex. J-213 (“Sales by Month by Product Line”).

Koeppel initialed the 2007 and 2008 work papers for the annual analysis and testified that “I suspect I would have looked at” the 2006 work paper when it was prepared. Exs. J-118 at 14 & J-214 at 14; Tr. 954, 965. The 2006 and 2007 work papers for the monthly analysis bear Koeppel’s initials, indicating her review of the procedures, and she testified that she would have typically reviewed the 2008 work paper as well, at least in draft form, and that it was consistent with her understanding at the time of the audit. Exs. J-24 at 3 & J-168 at 6; Tr. 1064-65, 1072-73. Another audit team member testified that Koeppel was very involved in analyzing and discussing the variances in the sales data. Tr. 180-85 (2006-2008 Staff/In-Charge Auditor).

As Koeppel was aware, however, those annual and monthly variation analyses were based on data in reports provided by Koss’s accounting department. *E.g.*, Tr. 983-86, 1000, 1009, 1078, 1349-50; Exs. J-25, J-118, J-214 (each annual analysis, which cross-referenced the other work paper, was documented in handwriting on “Detail Schedule By Company, Income Statement, Koss Corporation”); Exs. J-24, J-168 at 5, J-213 at 20 (audit work papers identifying Koss reports used in the monthly analyses). There is no indication in the record that in the current or prior year audit procedures were applied to those Koss reports to support their reliability. *See, e.g.,* Tr. 1000; Ex. D-4 at 105 (Audit Manager’s investigative testimony). Koeppel testified that consistency of the product line groupings was a fundamental question that needed to be asked when performing such a variance analysis, though she was not specifically aware of it having been asked during the Koss audits. Tr. 987-88, 1067-68; *see* Tr. 151-52 (similar testimony from 2006-2008 Staff/In-Charge Auditor). Koeppel further testified that it was not part of the approach or execution of the audits to test whether sales were allocated consistently to accounts between periods or assigned properly to each month. Tr. 940-41, 946, 961-65, 987-90, 995-96, 1000, 1010-13, 1067-68, 1080-83, 1409-10, 1488; *see* Tr. 151-52, 196, 220-21; Ex. D-4 at 120 (Audit Manager testified in investigation to being on the same page with Koeppel on these points).[16/]

For all of the analytical procedures performed in the Koss audits, Koeppel testified that to identify significant unexpected differences from expectations, the auditors used as a "baseline" the "tolerable error" amount established for the audit ($330,000 for 2006, $260,000 for 2007, and $220,000 for 2008), made judgmental determinations about whether variances that exceeded, or were less than, tolerable error should be investigated, and evaluated differences that they concluded were both significant and unexpected. Tr. 840-43, 1015, 1069-70 (Koeppel); *see* Tr. 140-42, 190-95, 206-09 (2006-2008 Staff/In-Charge Auditor); Ex. J-26 Exs. R-202 at 3, R-295 at 2, R-393 at 3 (audit work papers stating tolerable error).[17/]

[16/] In briefing, Koeppel cites an additional procedure in the 2007 and 2008 audits not noted by any expert witness. She refers to it, without discussion at the hearing or in briefing, as an "Export Sales Analysis" relevant to testing of Koss's April 30-June 30 accounts receivable. KOB 50 (citing only 2008 procedure); KPHS 40-41 (citing it in both years). The work paper for the procedure purported to contain a breakdown of sales to customers in Koss sales territory #55 by month and quarter for the current and prior fiscal years, along with year-to-date totals, listing percentage changes between the two years in the quarterly and annual totals, all apparently based on attached Koss printouts titled "Customer Sales History By Territory Within Company #" as of May and June of the current year. Exs. J-146 ("Koss Corp. Q4 Export Sales (Europe), A: 06/30/07") & J-231 ("Q4 North American Export Sales, A: 6/30/08"). As the Division points out (DRB 30 n.157), there is no evidence in the record that any audit procedures were applied to those Koss reports to support their reliability, and on the face of each work paper, there is no evidence that anything more was done than to agree prior-year figures to the prior-year work papers, test for clerical accuracy, and trace fourth-quarter and year-to-date totals and the percentage change from prior year to a press release. The procedure appears only to have addressed around a third or less of Koss's purported total fourth-quarter sales. *See, e.g.*, Exs. J-116 at 1, J-118 at 1, J-213 at 1, J-214 at 1.

[17/] Koeppel testified that tolerable error represented an estimate of the maximum amount of misstatement that could be accepted in an individual account or a group of related accounts. Tr. 840-42; *see generally* AU §§ 350.18 ("tolerable misstatement" is "a planning concept and is related to the auditor's preliminary judgments about materiality levels in such a way that tolerable misstatement, combined for the entire audit plan, does not exceed those estimates"), .48.

The work papers for the analytical procedures contain examples in which particular variances from expectations were identified as warranting evaluation and explanations were offered. *E.g.*, Ex. J-17 at 3; Ex. J-18 at 2; Exs. J-25 at 1 & J-26; Ex. J-115 at 1; Ex. J-147 at 1; Ex. J-163 at 2; Ex. J-212 at 2; Ex. J-223 at 2, 4; Ex. J-266 at 1-2, Tr. 1053-58. But repeatedly, differences that exceeded tolerable error went without any documented evaluation or explanation for why one was not made. *E.g.,* Ex. J-25 at 1 (“Mass” sales), Tr. 143; Ex. J-144; Ex. J-213 at 1-3, 13-14, 18-19 (certain sales), Tr. 216-220, 1063-73; Ex. J-254; Ex. J-255; Ex. J-257; Ex. J-264 (no explanations of variances), Tr. 491-92. Further examples, in work papers specifically signed off on by Koeppel, include Ex. J-23, Tr. 943; Ex. J-24 ($1 million decrease in April net sales compared to prior year), Tr. 947-49; Ex. J-147; Ex. J-168 at 2 ($665,000 decline in “Mass” sales), Tr. 990-92; Ex. J-241; Ex. J-260; and Ex. J-262.

Other audit procedures cited by the parties (*e.g.*, KPHS 40, 41) that are specific to net sales involve scanning end-of-fiscal-year Koss sales data, to address the existence or occurrence of its revenue. Each year, the revenue audit program included the two steps, “Scan the sales records for the last business day of the year for large or unusual entries and verify that they were recorded in the proper period” and “Scan the revenue accounts in the general ledger for large or otherwise unusual entries.” Exs. J-16 at 1, 4, J-110 at 3, 4, J-210 at 2, 3; *see* Tr. 1429-32 (Koeppel); Tr. 357, 366, 368, 382 (2006-2008 Staff/In-Charge Auditor); Tr. 664 (2007-2008 Staff Auditor).

As to the former step, in addition to cross-referencing shipping “cut-off testing” (which did not involve the tracing of invoices to a sales account, Tr. 401, 713-14, and is discussed in the next section below), there was a notation on the audit program in 2006 and 2007. The notation stated, “GT reviewed the sales records for the last week of June noting no large or unusual entries” (Exs. J-16 at 1, J-110 at 3; Tr. 664-66, 668-69); and in 2008 stated, “To complete this step, GT reviewed the sales journal for the end of June 2008. Per review, GT noted no entries greater than Tolerable Error of $220,000 and no entries which GT would deem unusual” (Ex. J-210 at 2).

As to the latter step, a 2006 entry stated, “GT reviewed the sales recorded during June on the AR Distribution Report (Sales Journal) and notes that nothing appeared unusual” (Ex. J-16 at 4); the 2007 and 2008 entries stated, “GT reviewed the ‘Month to Date – Commissions’ report as of [6/30/2007 or 6/30/2008] which includes all sales detail during the month of June. Per the review of this report, there were no unusual or significant items noted that need further investigation. As such, no further work is required” (Exs. J-110 at 4, J-210 at 3). Koeppel specifically signed off on the last-noted, 2008 entry. Ex. J-219 at 1; see Tr. 1429-32, 1434 (Koeppel).

Thus, these audit tasks were performed using Koss system-generated reports provided by its accounting department and without accessing its electronic general ledger. Tr. 383, 1434. Moreover, there was no audit documentation or testimony that the reports were reconciled to Koss trial balance reports. Tr. 385. When questioned about this at the hearing, an audit team member expressed the view that reconciling company reports to the general ledger was generally important to do because “[i]t adds to the validity of the support that they’re providing,” and also noted that Grant Thornton “told us maybe a million times if [work] wasn’t documented, it wasn’t done,” but stated that the reconciliation was not necessary for the review of the end-of-year sales records because “It’s not specifically that we’re tying in a balance. This is just some additional analysis of large or unusual records recorded at or near year-end, so it’s more of a specific kind of review of items.” Tr. 266, 385-86 (2006-2008 Staff/In-Charge Auditor). In response, however, to the question from Division counsel at the hearing, “If you didn’t have a complete set of sales for the last week of June, how could you get comfort that, in fact, your scanning procedure was, in fact, appropriate?”, another audit team member recognized, “It would not be ideal.” Tr. 716 (2007-2008 Staff Auditor).

b. Special sales allowances

As noted, Koeppel testified that in the 2006, 2007, and 2008 audits she relied, in part, in assessing Koss’s net valuation of sales, on the audit testing of the sales incentives that Koss recorded as a reduction to sales on its income statement and as a liability on its balance sheet. Tr. 845-46, 1082, 1119, 1127; *see* OIP 20 ¶ 74; Ans. 31 ¶ 74. Koeppel has admitted that in each audit she understood Koss’s sales incentives program, including the particular sales allowances pertinent here and that they were a judgmental accrual, and was aware of the audit testing of the management-prepared schedules that purported to show the activity in those allowances. OIP 20 ¶ 75, 21 ¶ 79; Ans. 31 ¶ 75, 32 ¶ 79; *see* Tr. 1117-21, 1135 (Koeppel: audit procedures regarding the testing of so-called special sales allowances were similar in all three audits), 1480; Tr. 184-85 (2006-2008 Staff/In-Charge Auditor had numerous discussions with Koeppel during the audits about the special sales allowance testing); Ex. J-41 (2006 “Accrued Special Sales Allowance Testing,” reviewed by Koeppel); Ex. J-52 (2006 “Credit Memo Analysis,” reviewed by Koeppel); Ex. J-152 at 15 (notation on 2007 audit program discussing approach to credit memo review around year end, reviewed by Koeppel); Ex. J-230 (2008 “Accruals Lead Descriptions,” reviewed by Koeppel, with an entry “[r]elate[d] to special sales allowances paid to customers”); Ex. J-248 (2008 work paper referencing review of fourth-quarter credit memos, reviewed by Koeppel).

At issue here are the sales incentives recorded in Koss’s “Accrued Special Advertising” or “Accrued Special Sales Allowance” balance sheet accounts, consisting of discounts and rebates, which, in the fiscal years 2006, 2007, and 2008, reduced the net sales reported on Koss’s income statement and constituted all or most of the amounts reported as the “Cooperative advertising and promotion allowances” component of the accrued liabilities line item on its balance sheet. *See, e.g.,* Exs. J-59 at 27, 36, J-172 at 28, 38, J-268 at 36 (Koss Form 10-Ks); Exs. J-43 at 2, J-136 at 2, J-229 at 2 (“Accruals Lead” sheets); Exs. J-44 at 2, J-137 at 2, J-230 at 2 (“Accruals Lead Descriptions”); Exs. J-41, J-133, J-226 (2006-2008 memoranda “document[ing] [the audit] understanding” of the “two components of the special sales allowance accrual” or the "2 different special sales allowance accounts" and approach to testing them); Exs. J-25 at 2, J-118 at 2, J-214 at 2 (contrarevenue accounts on Koss's June 30, 2006, 2007, 2008 detailed income statements); Tr. 1016, 1117-21, 1127-29 (Koeppel); Tr. 176-77, 182, 344-47 (2006-2008 Staff/In-Charge Auditor); Exs. R-509 at 154-55 & D-4 at 121-23 (Audit Manager's investigative testimony).

Koss offered these so-called "special sales allowances" either (1) in fixed dollar amounts, payable by month or by quarter, for specific situations or (2) based on a percentage of sales that could be subject to negotiation and change by VP-Sales every year, every month, or every other week. Exs. J-41, J-133, J-226 at 1; Exs. J-40 at 1, J-134 at 1, J-227 at 1; Exs. J-44 at 2, 4, J-137 at 2, J-230 at 2, 4; Ex. J-52 at 6; Ex. J-228 at 1; Tr. 152-55, 174-75 (2006-2008 Staff/In-Charge Auditor). According to a 2006 audit work paper, Koss's customers eligible for them "can come back at any time to redeem the accrual whether it be one year later or three years later." Ex. J-52 at 6. Consistent with the understanding expressed in 2006 and 2007 as well, a 2008 audit work paper stated generally, "These allowances are not firm commitments and nothing is in writing to verify the fixed or percentage allowance given to customers." Ex. J-226 at 1; *see* Exs. J-41 (2006) & J-133 (2007); *see also, e.g.,* Ex. J-227 at 1 (2008: "Per [VP-Finance] and [Senior Auditor], there are no formal contracts to validate the fixed allowance payment."); Exs. J-38 at 1, R-274 at 826, J-225 at 1, R-482 at 723 (internal control findings from 2006, 2007, 2008); Tr. 1121-27 (Koeppel); Tr. 476-82 (2007-2008 Staff/In-Charge Auditor); Tr. 173-74 (2006-2008 Staff/In-Charge Auditor: sales allowances not in writing, with couple of exceptions of customers with fixed allowances).

The work paper also noted, "As we are relying on management's representation to determine reasonableness and adequacy of the accrual, GT has added this issue to the management representation letter." Ex. J-226 at 1; *see* Ex.J-280 at 4 (August 22, 2008 Koss letter to Grant Thornton: "There are no formal contracts or agreements in place that document the terms of the sales allowance program with customers. Management believes the Special Advertising Accrual is reasonable and adequate."). At the hearing, Koeppel explained, "I felt it was important on a judgmental accrual when we could not tie to third-party support or a contract to make sure that management understood that we were relying on their representation that this was a complete and accurate and reasonable accrual at the end of the period." Tr. 1403. Having identified the special sales allowance program's lack of formalized contracts as a control deficiency in 2006 and 2007 (Exs. J-39 at 4, J-132 at 3), Koeppel designated it as a significant control deficiency in 2008 (Ex. J-239 at 7). She testified this was a situation in which "I don't have anything to tie [the account balance] to, and so we perform work that we can, but as it related to special sales allowances, I was uncomfortable with the fact that management had not addressed it by doing anything different and wanted to make sure that it was elevated to a higher level of importance in 2008 to the audit committee and also include it in the representation letter," such that President/CEO "was clearly aware that this was a concern." Tr. 1195-96; *see* Ex. 227 at 1.

Koss estimated the amount of sales allowances it expected to grant to each customer to whom they were offered, but no audit procedures were performed to test whether or not the customers had reached the qualifying sales volumes because, as Audit Manager explained in the investigation, "So while [Koss] represented to us that it may have [been that customers] had to reach 100,000 in sales and they get 5 percent, it really could have been anyone's guess. It was a representation based by management that this is what they had agreed to, and there weren't formal contracts." Ex. D-4 at 123-24. Another 2008 work paper summarized the implications of the situation at Koss this way: "given the limited amount of information provided to us (i.e. no support for percentage or fixed allowances), GT notes there is no way to fully validate the allowances given." Ex. J-227 at 1; *see* Tr. 474-79 (2007-2008 Staff/In-Charge Auditor).

In each audit, Koeppel tried to assess the reasonableness of the fiscal year-end amount of special sales allowances recorded by Koss, representing the amount of the discounts and rebates that had been earned by customers but not yet paid to them or deducted from Koss's accounts receivable. The auditors obtained from Koss's accounting department a paper copy of an allowance schedule generated by Koss's IT system and variously described by the work papers as a "spreadsheet" or "rollforward." Exs. J-41 at 1, J-133 at 1, J-226 at 1; Tr. 156-62, 167-70, 183 (2006-2008 Staff/In-Charge Auditor). It purported to list, for each customer that received the allowances during the fiscal year, each month's opening balance, allowance activity, and closing balance. Exs. J-42, J-135, J-228. Although in each audit this report was used in performing certain procedures, no procedures were applied to the report to substantiate management's assertions that it was complete. Tr. 171-73, 183-185 (2006-2008 Staff/In-Charge Auditor trusted that Koss's accounting department gave her a complete listing, never performed any procedures to ensure it was complete, and had numerous discussions with Koeppel about the special sales allowance audit work), 397, 1132.

Rather, on a customer-by-customer basis, the auditors compared the July 1 opening balance on the current year's spreadsheet to the June 30 closing balance on the version used in the prior year's audit. Exs. J-41 at 1, J-133 at 1, J-226 at 1; Tr. 162-66. They also tied the total outstanding balance at the current fiscal year end to a trial balance report generated by Koss's IT system. Ex. J-42 at 7, J-43 at 2, J-44 at 2 (2006); Ex. J-135 at 5, Ex. J-136 at 2, Ex. J-137 at 2 (2007); Ex. J-228 at 4, Ex. J-229 at 2, J-230 at 2 (2008); Tr. 347-50, 395-96, 1404. They did not tie the balance on the spreadsheet, representing balance sheet accounts, to a report of the details of the corresponding contrarevenue accounts on the income statement because, according to Koeppel, that was not part of the methodology of the audits. Tr. 185, 1082-83, 1409-10. Koeppel summarized the foregoing audit work as follows: "We tied the total of the report to the GL [meaning a trial balance report], indicating that the…accrued balance was supported by specific accruals or reserves for each individual customer who had a[n] incentive program or a co-op allowance….We performed some clerical tests on that report, too, indicating that it flowed through appropriately. So we had a reasonable basis to determine that the report was accurate." Tr. 1404.

Furthermore, the auditors tested a sample of the claims activity depicted on Koss's report. "GT haphazardly selected 5 customers from the 65" customers for 2006 and 2007 and the 52 customers for 2008 shown on the spreadsheet as "receiving a special sales allowance, and two months of sales activity, for testing." Exs. J-40 at 1, J-134 at 1, J-227 at 1. For these five customers, the auditors checked the mathematical accuracy of the spreadsheet's calculation of the running totals, from month to month throughout the year, of available allowance amount. Each year, four of the selected customers were listed by Koss as receiving allowances on a percentage-of-sales basis and one on a fixed-amount basis. For two selected months in non-consecutive quarters (or in one case in 2006 of a customer to whom no sales were made in either of those months, "additional months"), the auditors recomputed each of the four customers' allowance percentages shown on the spreadsheet for the month by dividing its allowance amount shown for that month by a corresponding sales figure, derived from a monthly sales report generated by Koss's IT system. Exs. J-40 at 1, 2 ("GL Sales Detail by Month"), J-134 at 1, 2 ("Customer Sales History by Terr With[]in Company #"), J-227 at 1, 3 (same). Also, "GT traced [the special sales allowance percentages for those months] to PY [prior year] noting percentages have not changed." Exs. J-40 at 1, J-134 at 1, J-227 at 1. *See* Tr. 1130-35 (Koeppel); Tr. 469-73 (2007-2008 Staff/In-Charge Auditor); Tr. 187-88 (2006-2008 Staff/In-Charge Auditor); Ex. D-4 at 123-24 (Audit Manager's investigative testimony). No audit procedures were applied to the sales reports used in the special allowance testing to determine their completeness or accuracy. Tr. 187-89, 473, 1134-35; Exs. J-40 at 2, 3, J-134 at 2, 3, J-227 at 3.

According to the work papers, for the one selected 2006 customer listed on Koss's spreadsheet as having a fixed-amount allowance, the auditors were able to review a written contract specifying the amount. Ex. J-40 at 1-2. Although a summary memorandum in the 2007 audit work papers (Ex. J-133 at 1), as in 2006 and 2008 (Exs. J-41 at 1, J-226 at 2), stated, "For those customers that accrued using the fixed allowance method, GT gained an understanding of how the amount is derived and traced to appropriate documentation," the 2007 detailed work paper contained a blank space next to the selected "Fixed-based" customer, with no indication that any procedures were performed or conclusions reached as to its allowance. Moreover, while the 2006 and 2008 work papers concluded that, based on the audit testing, the special sales allowances were or appeared to be properly calculated (Exs. J-40, J-227), the corresponding 2007 work paper stated no conclusion. Ex. J-134 at 1; Tr. 185-87 (2006-2008 Staff/In-Charge Auditor). According to the 2008 work paper, the testing of the allowance for the "Fixed-based" customer selected for that fiscal year was limited to "vouch[ing] a payment (in the form of a credit memo)." Ex. J-227 at 1.

Work papers for the 2006 and 2007 audits stated that, in addition, "GT tested one [allowance] claim [included on Koss's spreadsheet] for each of the [five] customer[]s selected" for the other testing by comparing the claim to a credit memo issued by Koss and noting that the claim was redeemed at the stated amount, but, in 2007, only four claims bear the relevant tick mark, none belonging to the five customers selected for the other testing. Ex. J-41 at 1 & Ex. J-42 at 1-3 (2006); Ex. J-133 at 1 & Ex. J-135 at 1, 4-5. In 2008, the auditors "haphazardly selected [from Koss's spreadsheet] 10 claims during the year for testing" by use of credit memos, three of which were for "fixed allowance rather than percentage based." Ex. J-226 at 2; Ex. J-228 at 1-4. The work paper for this testing in 2006 stated the conclusion that "accrual is reasonable at 6/30/06" (Ex. J-42 at 2), whereas the counterpart work paper for 2007 and 2008 stated no conclusion (Ex. J-135 at 2 (left blank); Ex. J-228 (no line item for conclusion)).[18/]

Regarding credit memos, the revenue audit program for each audit included the work step of "[o]btaining or prepar[ing] a schedule of sales returns" for the beginning of the next fiscal year and "identify[ing] large or unusual items to verify that they were recorded in the proper period." Exs. J-16 at 1, J-110 at 3, J-210 at 2. Noting the "close" proximity of the final field work to fiscal year end, the auditors stated that they instead (1) "reviewed credit memo activity prior to year end," "assuming the activity would approximate activity subsequent to year end," as part of the field work, which was described in the 2006 and 2007 work papers as "the primary test," and (2) "will review credit memos issued subsequent to year end" but before Koss's filing of its Form 10-K as part of post-field-work audit update procedures. Exs. J-16 at 1 & J-110 at 3, 5; Exs. J-52 at 1 & J-152 at 1, 6; Ex. J-248 at 1; Tr. 406-07 (2007-2008 Staff/In-Charge Auditor); Ex. R-509 at 159, 172-73 (Audit Manager's investigative testimony).

[18/] The documentation for each audit contained an "Accruals Lead" work paper that consisted of handwritten notations on a Koss IT-system generated report called "Detail Schedule by Company, Balance Sheet, Koss Corporation, Period Ending June 30," which included account totals for the special sales allowances for the end of the current and prior fiscal years. Exs. J-43, J-136, J-230. This was accompanied in each audit by an "Accruals Lead Description" work paper, which purported to address the difference in those totals. For 2006 and 2007, the stated analysis consisted simply of a cross-reference to the above-described audit work for the proposition that "rates and fixed amounts are consistent with PY and deemed reasonable." Exs. J-44 at 2, 4 (item M), J-137 at 2 (item M); *see* R-231 at 1 (notation on 2006 accruals audit program cross-referencing Accruals Lead and Accruals Lead Description); Tr. 344-47 (2006-2008 Staff/In-Charge Auditor). In 2008, the work paper stated, as to the year-over-year difference, that "allowance reduction is reasonable" based on a cross-reference to the above-described audit work, along with a recitation of an untested assertion by VP-Finance and a general citation to separate credit memo testing (which we discuss next): "GT noted a significant decrease in the accrual which is against our expectations [that it also would remain consistent due to the consistency of sales between years]. PDW [VP-Finance], the decrease is due to the fact that many customers did not meet their minimal sales requirements in order to earn the special sales dollars. In addition, several customer allowances were reduced through issuance of credit memos. See testing of credit memos @ [work paper number] 7006." Ex. J-230 at 2, 4.

In 2006 and 2007, what was described as the field work component of the credit memo "review," although focused on the returns reserve, assessed the adequacy of the special sales allowance accrual (or reserve) at fiscal year end, apparently as reflected in a trial balance report, by comparing it to the total amount of the credit memos attributable to special sales allowances on a management-prepared schedule of "all credit memos issued in the last quarter of the year." Exs. J-52 at 1-6, 10-11 & J-152 at 1-4, 14-15 ("Credit Memo Analysis" work papers); *see* Exs. J-43 at 2 & J-136 at 2 (Koss detailed balance sheets). In addition, "GT haphazardly selected" 10 to 12 items on Koss's fourth-quarter credit memo schedule and traced them to a copy of the underlying credit memo, "to verify the accuracy of the schedule." In 2006, part of testing the returns reserve involved dividing the credit memos on Koss's fourth-quarter listing into six categories "by relying on the description given and [Senior Auditor's] assistance," and totaling the balances of the four of those categories related to returns to obtain a "High-end range," "assum[ing] a 3-month lag" for the reserve. Ex. J-52 at 6, 7.

The counterpart in the 2008 audit to these "Credit Memo Analysis" work papers, entitled "Returns Reserve Analysis," stated that "GT reviewed the credit memo listing for the 4th quarter of FY'08 noting no large or unusual credits." Ex. J-248 at 1; *see* Tr. 406 (2007-2008 Staff/In-Charge Auditor). No mention was made there of any other accrual or reserve than sales returns (as to which a notation was made that "historically, returns have been low") or of any procedure applied to Koss's credit memo listing. Ex. J-248. Entries on the audit programs each year noted that, during field work, inquiry was made of VP-Finance, who asserted that "there were no write-offs or larger [or "significant"] credit memos issued subsequent to" year end. Exs. J-16 at 5, J-110 at 5, J-210 at 4.

The documentation of the post-field-work credit memo "review" in 2006 described it as comparing two items on a Koss-prepared listing of credit memos to the underlying credit memos and in 2007 and 2008 described it as scanning a Koss-prepared credit memo listing for significant or unusual items and also in 2006 and 2008 as comparing the total balance of credits listed since year end with the returns reserve.[19/]

[19/] **2006**: Ex. J-16 at 5 ("GT will review credit memos issued subsequent to year-end in Septembe[r] before the 10-K is filed."), Ex. J-52 at 1 (similar), Ex. J-51 at 1-2 ("GT selected all credit memos over $5,500 (1/2 of Listing Scope) through 8/28/2006, the last day of fieldwork from a Credit Memo Analysis, listing all credit memos issued since YE. This analysis was prepared by Koss."; $5,900 special sales allowance item and other $9,963.14 item on the listing were "T/A to credit memo"; "Based on testing performed above, GT deems subsequent credit memos to be reasonable. Based on total credit memos issued through 8/31/06, GT deems the reserve at YE to be adequate. Further, as no credit memos issued as of 8/31/06 are individually significant[], GT will pass on any other work."); **2007**: Ex. J-110 at 5 (after inquiry of VP of Finance during field work, "[s]ubsequent credit memos will be reviewed again in the post fieldwork update audit procedures…to be completed before the filing of the 10-K."), Ex. J-151 ("GT reviewed the credit memos listing from 6/30/07 through 7/19/07 noting nothing significant or

As Koeppel knew, no effort was made in the accounts receivable confirmation testing in any of the audits to confirm with customers the terms or amount of any sales allowances they might have received from Koss. Tr. 1404-05; *see* Ex. R-509 at 174-78 (Audit Manager's investigative testimony). The work papers for the three audits document, however, just over a dozen total instances in which alternative audit procedures used when an invoice or debit memo was not confirmed involved matching the unconfirmed amount to a debit memo (a sales allowance claim) or a credit memo (a granted sales allowance), as to one customer identifying the type of allowance ("coop allowance"). Exs. J-30 at 1-2, J-123 at 1-8, J-220 at 44-46.

c. Accounts receivable

In the 2006, 2007, and 2008 audits, the existence of Koss's accounts receivable at the June 30 balance sheet date was tested principally by performing procedures as of an April 30 interim date. *See, e.g.,* KOB 18; OIP 14-15 ¶¶ 46-47, 15-16 ¶ 51; Ans. 22 ¶¶ 46-47, 23 ¶ 51; Tr. 876-77, 918, 1360 (Koeppel); Exs. J-16, J-110, J-210 (2006-2008 audit programs for revenue). Koeppel explained that the interim procedures consisted primarily of confirmation testing of a sample of outstanding Koss unpaid invoices as of April 30, "an area that I would focus on" during the audits. Tr. 1353 (the primary test of details used to obtain audit evidence on Koss's accounts receivable was "[c]onfirmations"), 1357. Confirmation requests were sent to customers to confirm the dates and amounts of the invoices or debit memos (representing sales incentive claims, *see, e.g.*, Exs. R-300 at 15, 21, R-398 at 15) chosen for testing, responses were reviewed, and alternative audit procedures were performed to try to verify receivables that were not confirmed. Exs. J-30, J-123, J-220; Ex. R-194 (2006 returned confirmations); Tr. 360-61, 402-03, 438-39, 876-78, 908, 935-38, 1353-55, 1358; Ex. D-4 at 58 (Audit Manager's investigative testimony). In addition to the interim audit work, substantive audit procedures were performed in an attempt to cover the remaining period from May 1 through June 30. *E.g.*, Tr. 887-89, 893, 918-19, 937-38, 1479.

As Koeppel knew, for the confirmation testing, the audit team selected a sample of receivables by obtaining an April 30 AR Aging Report (a subledger listing generated by Koss's IT system of all outstanding receivables at a given point in time), and, according to Koeppel, modifying the report in certain respects. Items as to which

unusual. As such, GT deems the reserves at 6/3/07 to be reasonable."); **2008**: Ex. J-210 at 4 (like Ex. J-110, plus notation, "No significant credit memos or writeoffs were noted during th[e] post fieldwork review."), Ex. J-246 at 1 ("GT reviewed the credit memo listing from 6/30/08 through 7/16/08, noting that $20,202 in credits have been issued subsequent to year-end. When considering the balance of the returns reserve @ 6/30/08 of $145,000…, GT considers the returns reserve to be adequate."), Ex. J-248 ("Returns Reserve Analysis") at 1 ("Per testing, GT noted no significant credit memos during our update audit procedures. Reasonable.").

"sending a confirmation would not be appropriate," in her view, were removed, such as intercompany accounts (transactions with a related party) and bankrupt customers' accounts specifically reserved for by Koss. Tr. 878-81, 905-12, 935-36, 1337-39 1359, 1408 ("the bulk of their operations was in one entity, but they actually had several other entities that they ran transactions through"); *see* Exs. J-30 at 4-5, 6, J-123 at 2, 10-12, J-220 at 1, 47, 48 (2006, 2008 sample selection and 2007, 2008 sample testing work papers, all reviewed by Koeppel); *see also* Tr. 433-37, 440-42, 444-46 (2007-2008 Staff/In-Charge Auditor); Ex. J-124 at 1, 83, 86 (2007 sample selection work paper).

In 2006, 2007, and 2008, the sample for the accounts receivable confirmation testing was drawn from an April 30 population of about $9.3 million, $6.8 million, and $4.7 million in gross receivables, respectively, compared to Koss's total net sales for those fiscal years of about $50.9 million, $46.2 million, and $46.9 million. Exs. J-30 at 1, J-123 at 2, J-220 at 44; Exs. J-59 at 26, J-172 at 27, J-268 at 25. Thus, even assuming all of Koss's recorded April 30 receivables related to sales occurring in that fiscal year, at least 81.7% to 90% of Koss's net sales each year was not subjected to the confirmation procedures in the Koss audits. [*See* D-2 at 63-65; Tr. 1578 (McGrath).]

Koeppel understood that, under AU § 350.24, items should be selected for testing in such a way that the sample could be expected to be representative of the overall population from which it was chosen. Tr. 881-83. She agreed that Grant Thornton's audit methodology at the time reasonably provided that, because an item erroneously excluded from a population to be sampled cannot be selected for testing, supplementary procedures should be performed to assure that the sample population is complete. Tr. 885; *see* Exs. J-60 at 160, J-139 at 269, J-269 at 273 (2006, 2007, 2008 firm manuals, stating that an example of such a procedure would be "footing the population and agreeing it to the general ledger"). As a Koss audit team member admitted at the hearing, receiving confirmations back from customers does not necessarily indicate that all items that should have appeared on the AR Aging Report were there. Tr. 403 (2006-2008 Staff/In-Charge Auditor).

In this regard, Koeppel testified that she believed it was a "customary procedure" to reconcile the accounts receivable balance used to perform confirmation testing to the client's general ledger. Tr. 908-09, 936-37. On this point, the parties' expert witnesses agreed. *See* Ex. R-507 at 69 (Koeppel expert: "reconciliations between the report used to perform accounts receivable confirmations and the general ledger is the preferable approach"), 94 ("it would have been preferable to have such a reconciliation"); Ex. D-2 at 36 (Division expert: reports used to select samples for confirmation of accounts receivable are "typically reconciled to the client's general ledger"; "it is a basic audit procedure to trace the total of an account analysis (such as an accounts receivable aging) to the general ledger control account, because of the audit risk that the general ledger may not agree to the subsidiary ledger"). During each of the three audits in question, Grant Thornton's audit manual stated, "Because an item erroneously excluded from a population to be sampled cannot be selected for testing, supplementary procedures should be performed to assure that the sampled population is complete (population completeness tests)." The manual then provided two examples of "[o]ther audit procedures [that] will often provide assurance about population completeness": (1) "footing the population and agreeing it to the general ledger"; and (2) "tests for unrecorded transactions and balances (e.g., search for unrecorded liabilities or unrecorded sales)." Exs. J-60 at 160, J-139 at 269, J-269 at 273.

It is undisputed that no such reconciliations were documented, performed, obtained, or reviewed in the 2006, 2007, and 2008 audits. *See, e.g.,* Tr. 886, 892, 908, 912-13, 935-37, 1361 (Koeppel); Tr. 405 (2006-2008 Staff/In-Charge Auditor); Tr. 445-46, 524-25 (2007-2008 Staff/In-Charge Auditor); Tr. 2095 (Koeppel expert); Exs. J-30 at 4-5, J-123 at 1, 8, 10-11, J-220 at 1, 47. A member of the 2007 and 2008 audit teams testified that "we didn't feel [such a reconciliation] was necessary" and explained that the modified accounts receivable balance "wouldn't have reconciled because we removed certain vendors." Tr. 435, 445-46, 524-25 (2007-2008 Staff/In-Charge Auditor). Only as of the June 30 balance sheet date did the auditors try to reconcile Koss's AR Aging Report to its general ledger, modifying the report balance by adding or subtracting items and comparing the resulting receivable balance to a trial balance report called a lead sheet generated by Koss's IT system, not to its electronic general ledger. Exs. J-32, J-126, J-221 (2006-2008 work papers, each reviewed by Koppel and each concluding "AR appears to be properly stated per the above testing"); Tr. 1359, 1366-67 (Koeppel); Tr. 364-65, 404-05 (2006-2008 Staff/In-Charge Auditor); Tr. 524-25.

As Koeppel notes (KOB 49), Koss's AR Aging Report was subjected to shipping cut-off testing in each audit. *See* Tr. 1362-64; *see also, e.g.,* Tr. 358-59, 400-01 (2006-2008 Staff/In-Charge Auditor); Tr. 671 (2007-2008 Staff Auditor); Ex. J-110 at 3; Ex. J-153 at 4. At interim, the testing compared Koss's last three product shipments before and first three shipments after April 30, based on Koss shipping documents and invoices, to its April 30 AR Aging Report, concluding that the report properly included or excluded these invoice amounts. Exs. J-28 at 1 ($3,552, $2,147, and $2,532 shipments before and $1,450, $254, and $32 shipments after April 30; reviewed by Koeppel), J-121 at 1-2 ($1,356.96, $1595.28, $1,436.40 shipments before, $36,858.36, $1,631.28, $1,546.32 after April 30), J-217 at 1-2 (three $175.70 shipments before, $1,923.84, $188.59, $720 shipments after April 30). Such audit testing was also performed as of the balance sheet date, using Koss's June 30 AR Aging Report. Tr. 1359; Exs. J-28 at 2 (shipments of $186, $9,823, $1,688 before and three $186 shipments after June 30), J-120 at 1-2 (shipments of $38.36, $881.50, $176.30 before, $176.30, $1,380.45, $176.30 after June 30), J-218 at 3 (shipments of $3,916.32, $175.70, $175.70 before, $3,065.34, $6,118.56, $119.00 after June 30) (all reviewed by Koeppel). Except for the June 2008 testing (Ex. J-218 at 3, Tr. 1448), these work papers purported to explain gaps between the numbers of the invoices selected, and Koeppel understood that Koss used "sequential invoice numbers," which, in her view, "was a good indication that there was appropriate cut-off" (Tr. 1364). The work papers variously stated the conclusions that based on the cut-off testing, "Koss appears to be recording inventory shipments in the correct period" and "AR is properly stated at 6/30/2006" (Ex. J-28 at 1, 2), "inventory shipments have been recorded in the proper periods" (Ex. J-120 at 1), and "inventory has been shipped and entered in the proper period" (Ex. J-218 at 3).

Audit team members who performed the procedure acknowledged, however, that the invoices subject to the cut-off testing, all dated immediately around period end, represented a very small or miniscule amount of the receivables on Koss's AR Aging Report at any given time. For example, the three June 2007 transactions that were examined totaled about $1,100, or .02% of Koss's $48 million in fiscal year gross sales, and the three transactions examined in April 2006 totaled only $8,000 and in June 2008 only $500. Tr. 712-13, 723-24 (2007-2008 Staff Auditor); Tr. 400-401 (2006-2008 Staff/In-Charge Auditor). Further, only the six tested items after April 30 and before June 30 each year fell within the rollforward period, which, according to Koss IT system-generated reports, encompassed total sales of well over $8 million in 2006 and 2007 and around $9 million in 2008. *See, e.g.,* Ex. J-18 at 1; Ex. J-31 at 1; Ex. J-115 at 1; Ex. J-125 at 1; Ex. J-213 at 1-2. And these team members did not trace the selected invoices to Koss's income statement sales account or regard the shipping cut-off testing as support for the completeness of the AR Aging Report. Tr. 713-14; Tr. 401-03.

In addition, Koeppel points to (KOB 49) work papers from the 2006 and 2008 audits stating that "GT haphazardly selected 10 invoices from the AR Aging as of" June 30 to assess whether the receivables were being properly aged and, according to the audit programs, thereby to "[t]est the allowance for doubtful accounts." This testing compared a copy of each of those invoices to Koss's June 30 Aging Report, finding that each invoice appeared in the correct "aging bucket" ("Current," "Past Due" or "Over 30," "Over 60," or "Over 90" days) in the report. Exs. R-227 & Ex. R-426 at 4-6; Exs. J-16 at 5 & J-210 at 4; *see* Tr. 1362, 1367-69. The 2006 work paper actually lists 12 invoices, which total $143,369.59 out of an overall June 30, 2006 AR Aging Report balance of $8,715,737.82. Ex. R-227 at 1; Ex. J-32 at 1. The 10 invoices listed in the 2008 work paper total $118,503.12 out of an overall June 30, 2008 report balance of $11,703,608.79. Ex. R-426 at 4; Ex. J-221 at 3. The 2007 audit program refers to "attached" "AR Aging Testing" (Ex. J-110 at 5), but the work paper, cited in passing in a Koeppel expert report, is not among the admitted exhibits, nor was testimony elicited about the details of that work. *See* Ex. R-507 at 29 n.89, 64 n.286, 72 n.320, 117 (expert's citation, corresponding to proposed exhibit R-333 on Koeppel's pre-hearing list (R.D. 49 at 12), which absent from her Index to Exhibits Admitted at Hearing (R.D. 79)).

In the 2006 and 2007 audits, to test the remaining period activity in Koss's accounts receivable account, a so-called rollforward of its receivable balance from the interim date to the balance sheet date was performed, using subledger and trial balance reports from Koss's IT system. Exs. J-31, J-125 (2006, 2007 work papers for the procedure, both reviewed by Koeppel); *see* Tr. 887-89 (Koeppel); Tr. 567-68 (2007-2008 Staff Auditor). As Audit Manager explained in investigative testimony, "we're opining on the financial statements as a whole as of a balance sheet date and for the [fiscal] year ending," and, "because we are not testing internal controls...we needed to do some substantive assessment to roll forward this material balance." Ex. D-4 at 90-92. Another audit team member further explained that, conceptually, a rollforward procedure involves taking a beginning balance that was tested at the end of an interim period and adding to it transactions that affect that balance in the remaining period to arrive at an ending balance that is reconciled with the general ledger. Tr. 567-68. Koeppel admittedly was aware of and approved the performance of this planned procedure in 2006 and 2007. Tr. 887-89, 894, 912-14; *see* Exs. J-31 at 5 & J-125 at 10.

The 2006 rollforward took Koss's April 30 accounts receivable balance from a Koss trial balance report, added to it Koss's May and June sales and credit balances and subtracted from it Koss's May and June cash receipts and Koss's inventory still on consignment at a retailer at the end of June ("Office Depot Reclass"), with a further addition or subtraction from the receivable balance for May and June cash in transit, depending on whether, and by the amount, that account had fallen or risen over the course of the month, to arrive at a June 30 balance. That resulting balance was then compared with a Koss June 30 trial balance report.

The sales and cash receipts data for each of the two months in the 2006 rollforward came from an AR Distribution Register, a monthly Koss subledger report that "gives a grand total of all invoices and cash distributions" for the month (*see* Ex. J-125 at 3). Ex. J-31 at 1, 4. The receivable balance thus "rolled forward" to June 30 was then compared to the June 30 balance reflected on a Koss trial balance report. *Id.* at 1-2 (noting but passing without further audit work a $3,463.98 difference). The work paper concluded, "Per the testing of the AR rollforward, AR appears to be properly stated as of year-end." *Id.* at 2. *See* Tr. 889-92, 894-99 (Koeppel); Tr. 576, 580-84 (2007-2008 Staff Auditor); Ex. D-4 at 90-92 (Audit Manager's investigative testimony).

The 2007 rollforward procedure took Koss's April 30 accounts receivable balance from a Koss trial balance report called a Detailed Balance Sheet, added to it Koss's May and June sales and credit balances, and subtracted from it Koss's May and June cash receipts, cash in transit, and certain other items, to arrive at a June 30 balance. The sales and cash receipts data for each of the two months again came from a Koss AR Distribution Register. The computed June 30 receivable balance was then compared to the June 30 balance on a Koss trial balance report, resulting in the same stated audit conclusion as in 2006. Ex. J-125 at 1, 2, 9. *See* Tr. 912-18; Tr. 568-73.

Additionally, in the 2007 audit, the AR Distribution Register reports used in the accounts receivable rollforward were reconciled to another Koss subledger report, some of the entries on which reports were compared to source documents. The work paper stated that the two reports were needed "[b]ecause of restrictions imposed by Koss's accounting system," namely that "a detailed listing of all cash receipts and invoices could not be produced." Ex. J-125 at 3; *see* Tr. 921-22 (Koeppel); Tr. 573, 575 (2007-2008 Staff Auditor). Instead, the auditors believed, Koss could only provide a listing of sales for a one-day period and so printed out the invoice listing every day and collected the accumulated reports in a binder maintained by Senior Accountant. Tr. 577.

Specifically, "to further validate the year-end A/R balance," "GT haphazardly selected 10 dates from the months of May and June" and "selected 1 cash receipt and 1 invoice from each date." Ex. J-125 at 3, 6, 10 (work paper, initialed by Koeppel). According to the work paper, the details of the selected invoices and cash receipts were traced and agreed to Koss invoices and checks or wire transfer payments. Also, the "detail of each invoice was traced and agreed" to Koss's Invoice Summary Register, a subledger report printed out daily "which displays invoice detail by date and provides a total of all invoices for a specific day." Ex. J-125 at 3, 6, 9; Tr. 576-80. Then "[t]he total of all invoices, by date" and "[t]he detail of each cash receipt" were tied to the corresponding day's entry in the AR Distribution Register, which "gives a grand total of all invoices and cash distributions" for the month and "ties directly to the revenue rollforward." Ex. J-125 at 3, 9. *See* Tr. 919-24, 927, 932-35; Tr. 564-67, 573-75. According to Koeppel, that "we tied in various reports…gave us comfort that the system was operating effectively and that the reports were accurate." Tr. 1406.

In addition, the record shows that in the 2007 and 2008 audits, the post-field-work audit update procedures included a "[r]eview of significant cash receipts" from a Koss-provided report. In 2007, the work paper stated, "GT reviewed all cash receipts listing from 6/30/07 through 7/27/07 noting nothing unusual or unexpected. Further, GT notes no receipts over TE of $260,000, as such, no testing deemed necessary." Ex. J-151. In 2008, "GT reviewed the cash receipt listing from 6/30/08 through 7/16/08, noting one significant cash receipt of $349,810 that was recorded" in July 2008; then "GT reviewed a copy of the wire transfer confirmation" and "a copy of the invoice," dated and showing shipment in late May 2008; and "[b]ased on this testing, GT conclude[d] that the sale and cash receipt were recorded in the correct period." Ex. J-246.

The accounts receivable confirmation testing showed that there could be a delay by the accounting department in applying cash receipts to reduce accounts receivable. With regard to one item not confirmed, a 2007 audit work paper stated, "Per review of lockbox printout, GT notes payment was received into Koss's bank account on 4/26/07. GT inquired with [Senior Accountant] to investigate. Per [Senior Accountant], A/R wasn't reduced until Koss received notification from the bank that the payment was actually received (notified several days later after 4/30/07. To adjust A/R as of 4/30/07 month-end, [Senior Accountant] makes a manual journal entry to increase cash and reduce A/R (via entry to a Cash-in-transit Account which offsets A/R….As payment was adjusted for as of month-end, GT deems client treatment proper." Ex. J-123 at 2-6. Similarly, another payment "was received (via wire-transfer on 4/30/07). PDW [Senior Accountant], a manual journal entry was made to increase cash and reduce AR at 4/30/07 (via entry to Cash-in-transit account with offsets AR…)." *Id.* at 3, 6.

There is no documentation or testimony that in the 2006 and 2007 audits, the April 30 receivable balance that represented the population sampled in the confirmation testing (derived from the AR Aging Report and limited to invoices and debit memos) was reconciled to the overall April 30 account balance (reflected on that same report or a trial balance report and representing not only invoices and debit memos but also offsetting cash receipts and credits) that was used to begin the receivable rollforward. Tr. 886, 892, 912-14 (Koeppel); Ex. R-509 at 170-74 (Audit Manager's investigative testimony); *compare* Ex. J-30 at 1 ($9,290,117 for 2006 sampling) *with* Ex. J-31 at 1 ($7,803,330 for 2006 rollforward), and Ex. J-123 at 2 ($6,821,607 for 2007 sampling) *with* Ex. J-125 at 1 ($6,835,022 for 2007 rollforward). Nor, it is undisputed, were any of the Koss system-generated reports used in the receivable rollforwards reconciled to Koss's electronic general ledger. *See, e.g.,* Tr. 1329, 1456-62 (Koeppel); Tr. 569-70, 583-84, 590-91 (2007-2008 Staff Auditor). And in 2006, no audit procedures were applied to the AR Distribution Register to obtain evidence of its reliability. Tr. 898-99 (Koeppel); Ex. R-509 at 160-61 (Audit Manager's investigative testimony).

It is also undisputed that in the 2008 audit no accounts receivable rollforward was performed for the remaining period. Tr. 937-38, 1365; Tr. 446-47. The work papers do not show any such rollforward, and no witness testified one was performed. Nor do the work papers document any reason why the rollforward was not performed in 2008 or denominate any other procedures as substitutes for the rollforward.

3. Inventory account

In the 2006, 2007, and 2008 audits, the existence of Koss's inventory at the June 30 balance sheet date was tested principally by performing procedures as of the interim date of April 30, including inventory observation procedures and related test counts of inventory on hand, which were then supplemented by audit procedures meant to cover the remaining period from May 1 through June 30. *See, e.g.,* KOB 18; OIP 17 ¶ 60; Ans. 26 ¶ 60; Tr. 1087-89, 1387-90, 1395 (Koeppel); Tr. 368-73 (2006-2008 Staff/In-Charge Auditor); Tr. 447-50, 454-56, 525-28 (2007-2008 Staff/In-Charge Auditor); Tr. 670, 674 (2007-2008 Staff Auditor); Exs. J-54, J-153, J-250 (2006-2008 audit programs for Koss's inventory purchasing). Koeppel is not charged with any violation for the conduct of the interim period audit work on Koss's inventory.

The charges before us in the inventory area focus largely on a so-called "rollforward" of the inventory balance from the interim date to the balance sheet date, performed in each audit using reports generated by Koss's IT system. Exs. J-33, J-127, J-222; *see* Tr. 1090-92, 1097-99, 1105-06, 1396-97 (Koeppel); Tr. 452 (2007-2008 Staff/In-Charge Auditor); Tr. 588-605, 673, 718 (2007-2008 Staff Auditor). Koeppel specifically signed off on the inventory rollforward in the 2007 and 2008 audits. Tr. 1097, 1104; Exs. J-127 at 10, J-222 at 9. The inventory audit program for the 2006 Koss audit, which Koeppel reviewed, was similar to that followed in the later years. *See, e.g.*, Tr. 373 (2006-2008 Staff/In-Charge Auditor). A cover page to the Koss inventory audit program in 2006, 2007, and 2008 contained a half-dozen answers to questions that helped tailor the work program, one of which was "Yes" an inventory observation would "be made prior to year end." Exs. J-54 at 1, J-153 at 1, J-250 at 1; *see* Tr. 369 (2006-2008 Staff/In-Charge Auditor), 1176-77 (Koeppel). She testified she "definitely" was aware that Koss's inventory was tested in the 2006 audit, understood that procedures were performed in each of the three audits to cover Koss's remaining period inventory activity, and believed that "inherent in our methodology," as applied in the Koss audits, was that "doing a roll forward" was part of what "gave us comfort that the system was working appropriately" and that Koss IT system-generated reports were reliable. Tr. 1092, 1186-88. Koeppel specifically signed off on the 2006 rollforward in the accounts receivable area that closely resembled the approach of the 2006 inventory rollforward. *See, e.g.*, Tr. 887-89, 894-99, 919-20; *compare* Ex. J-31 *with* Ex. J-33.

The rollforward procedure added the April 30 balances from eight to eleven inventory subaccounts, as reflected in a Koss trial balance report, and, using several Koss subledger detail reports, either added or subtracted May transactions affecting the inventory account, such as purchases, cost of sales, inventory in transit, prepaid inventory, returns, scrap, and adjustments, to derive a month-end May balance. Koss's monthly Detail Inventory Accounting Listing was used as the source of remaining period data on the two single largest items in the rollforward—inventory purchases (added in the rollforward) and cost of sales (subtracted)—as well as several miscellaneous items. Two other Koss detail reports provided data on returns (added in the rollforward) and scrap from returns (subtracted). Exs. J-33, J-127, J-222.

The inventory account balance thus "rolled forward" from April 30 to May 31 was then compared to the sum of the May 31 balances of the same eight to eleven inventory subaccounts from a Koss trial balance report. The process was then repeated for the month of June, using the May 31 sum as the starting point and going through the same process for June as for May. The audit work papers noted differences between the rollforward balances and trial balances at the end of May and June: -$732 and -$2,222 in 2006; -$6,124 and +$7,228 in 2007; -$9,833 and -$1,238 in 2008, respectively. No explanation for the differences was obtained, however, because the amounts were below tolerable error for the audits. Exs. J-33 at 2, 5, J-127 at 2, 5, J-222 at 2, 5.

There is no audit documentation, or testimony, that in any of the three audits the April 30 balance reflected on the detail report generated by Koss's IT system that was used to select a sample of inventory for the interim date audit testing, called an Inventory Listing, was reconciled to the sum of April 30 trial balances that was used to commence the inventory rollforward. Tr. 455-56, 594, 673, 676, 718-22, 1094-96, 1102-04, 1112-14, 1392; *compare* Ex. J-56 at 4, Ex. R-196 at 1 ($8,946,732 for sampling) *with* Ex. 33 at 1 ($9,312,614 for rollforward), Ex. J-154 at 1 ($7,928,996 for sampling) *with* Ex. J-127 at 4 ($9,275,963 for rollforward), and Ex. J-251 ($6,791,865 for sampling) *with* Ex. J-222 at 1 ($8,179,922 for rollforward). Koeppel acknowledged at the hearing, "There's differences between the general ledger, which includes multiple account balances"—including inventory in transit and prepaid inventory—"and the report [used at interim to select inventory for test counts], which is going to be specific to inventory that is on location" at Koss for physical observation. Tr. 1192, 1396-97; *see* Tr. 673, 675 (2008 Staff Auditor). Further complicating the matter in 2008, as Koeppel knew from review of the 2008 inventory test count work paper, "the inventory population increased by $147,644 (from $6,791,865 to $6,939,509) from the unadjusted to the adjusted listing" "[d]ue to (1) count adjustments made during physical [count] and (2) updates to standard costs." Ex. R-433 at 1, 7 ("This change is less than the planning materiality of $220,000, as such GT will pass on further investigation.").

Based on the work step "Foot and extend the inventory listing and agree with the general ledger control" on the Koss inventory audit programs, accompanying notations, and evidence that Koss trial balance reports were used as "the general ledger control" in the audits, the Koss Inventory Listing was reconciled to Koss's general ledger only through a Koss trial balance report and only at the end of the fiscal year. *E.g.*, Ex. J-47 at 2. And even then, the auditors did not check that the total balance and each of the subtotals stated on the Inventory Listing was in fact the sum of all of the individual items on the entirety or respective subsection of the report. That is, the auditors did not "foot" the entire report. *See* Exs. J-54 at 5 ("GT tested a portion of the year-end physical inventory listing to see that it footed. The inventory listing was only in paper. C[l]erical accuracy was tested by footing one section. The section footed w/o/e."), J-153 at 5 ("As it is only available in paper form, GT tested a portion of the 06/30/2007 Physical Inventory Report to ensure subtotals properly footed. The accuracy of the report was validated by footing one section of the report, noting it footed w/o/e."), J-250 at 6 ("As the physical inventory report is only available in paper form, GT footed a selection of the report, noting it footed accurately."); *see also* Ex. R-196 at 2, 4-5 (2006 Substantive Sample Workpaper). Moreover, it is undisputed the auditors did not reconcile any Koss reports used in the inventory audit work directly to Koss's electronic general ledger. *See, e.g.*, Tr. 1329, 1456-62 (Koeppel); Tr. 569-70, 590-91 (2007-2008 Staff Auditor).

The charges also focus on analytical procedures performed in the 2007 and 2008 audits that compared the April and May month-end balances of the categories of data used in those year's inventory rollforwards with the balances at those month ends in the prior year. Exs. J-128, J-223; Tr. 1400. The procedure was specifically signed off on by Koeppel in the 2008 audit. Ex. J-223 at 7. In the analyses, explanations were sought from Koss's Vice President of Operations (VP-Operations) and deemed satisfactory for the overall increase or decrease in month-end May or June inventory compared to the year before, and for what the auditors viewed as one or two of the most significant variances by category of data (*e.g.*, prepaid inventory, purchases, finished inventory on hand, inventory in transit). Ex. J-128 at 2, 4; Ex. J-223 at 2, 4; Tr. 603-24, 675. Koeppel testified that she understood that VP-Operations, who was not part of Koss's accounting department, "had been in that role for many years" and "had very good hands-on knowledge of the activities and operations that related to inventory." Tr. 1388; *see* Ex. R-509 at 573-74 (Audit Manager claimed in investigation that VP-Operations was "all over her cost sales numbers and her inventory purchases and any variances left and right" and VP-Sales, "as it relates to monitoring sales in general, and looking at commissions, knew what he was selling"); Tr. 681-82 (2007-2008 Staff Auditor, who performed the 2008 rollforward analytical procedures, stated that on rare occasions during Koss audits he spoke to VP-Sales). The underlying data for these analytical procedures came from the same reports used in the rollforwards. *E.g.*, Tr. 606.[20/]

Among the audit work specific to the inventory area that Koeppel has cited in this litigation (*see* KOB 18, 30; KPHS 42-43; Tr. 1092, 1099-1100, 1107, 1110, 1399-1400) is a procedure, accompanying the inventory rollforwards in 2007 and 2008, "to further validate the year-end inventory balance" by testing certain shipments and receipts occurring between May 1 and June 30. Specifically, "GT haphazardly selected" 10 receipts and 10 shipments each in May and June from the respective Detail Inventory Accounting Listing and "traced the activity to supporting documentation," namely shipping orders, invoices, and more Koss IT system-generated reports (receiving reports and a cost of sales (scrap) report also used in the rollforward procedure). Exs. J-127 at 7-9, J-222 at 6-8. The work papers did not specify the dollar amounts of the 20 shipments; the 20 receipts totaled about $567,000 for 2007 and $573,000 for 2008, out of total May-June inventory purchases for those years, according to the Koss data used in the rollforwards, of $4.4 million and $4.2 million, respectively. Exs. J-127, J-222. For each of these further tests, the conclusion stated in the work papers was that inventory receipts and shipments were properly recorded or accounted for as of May and June. Exs. J-127 at 7, 8, J-222 at 6, 7.

A member of the Koss audit teams claimed this further testing "provides some support for the validity" of the Detail Inventory Accounting Listing, but conceded that the only support provided is that the report contains data from 20 transactions compared to it each year and that this testing "does not satisfy completeness." Tr. 595-96, 601-03, 606 (2007-2008 Staff Auditor). Another member agreed that procedures were not applied to the report to determine its completeness. Tr. 453 (2007-2008 Staff/In-Charge Auditor). Koeppel repeatedly described the approach of not doing so as "inherent in our methodology," as applied in the audits. Tr. 1092, 1100, 1107-11, 1390, 1394.[21/]

[20/] A separate trend analysis was also performed in each audit that compared the current and prior fiscal year-end inventory balances, as reflected on Koss trial balance reports, though it used a different June 30 inventory balance than did the rollforward procedures. *See* Exs. J-47, J-147 at 3-4 (reviewed by Koeppel), J-234 (same).

[21/] The same reports were used on a task that appeared on the inventory audit programs for the 2007 and 2008 Koss audits. That work step read, "Scan the entries in the general ledger inventory control account during the rollforward period for unusual activity," but a notation stated that "[p]er review" of the Detail Inventory Accounting Listings for May and June, "there were no unusual or significant items that require additional investigation" and "no unusual activity is noted." Exs. J-153 at 5, J-250 at 6.

Additionally, Koeppel points out audit work summarized in a work paper as “GT calculated certain key inventory-related ratios and compared the ratios to the prior year in order to identify significant trends and outcomes that differ from expectations” (Ex. J-252 (2008 audit); *see* Exs. J-57 & J-156 (2006, 2007 work papers); Exs. J-54 at 4, J-153 at 5, J-250 at 6 (2006-2008 inventory audit programs). This work, performed in each of the three audits, entailed listing balances for sales, cost of goods sold, inventory, and accounts payable as of June 30 of the current year, tied to Koss trial balance reports, alongside the balances for the prior year (or in the 2008 audit, the balances for the two prior years), making calculations of ratios for each year’s gross profit, inventory turnover, days sales in inventory, and accounts payable turnover, and noting the differences between the ratios from the one year to the next. Audit inquiry was then made of VP of Operations and, in one instance in 2008, of Junior Accountant, about the differences between the last three ratios (the differences between the gross profit ratios each year were viewed as too small to warrant inquiry). No further follow-up was deemed necessary, according to the work papers.[22/]

Finally, Koeppel cites cut-off testing of inventory receipts. In each audit, this testing consisted of comparing information about the last three Koss inventory receipts before and after April 30 and June 30, drawn from “an inventory listing by invoice” generated by Koss’s IT system, with receiving reports, invoices, and an inventory parts number report. Exs. J-55 (tracing inventory receipts of $4,500, $4,317.30, and $42,500 before and $7,540.85, $2,860, and $1,688.28 after April 30, 2006), J-121 (receipts of $54,740, $3,712.80, and $7,056 before and $27,216, $409.20, and $10,800 after April 30, 2007), J-155 (receipts of $14,664, $800, and $1,248 before and $24,300, $34,925, and $18,638 after June 30, 2007), J-217 (receipts of $1,697.28, $66.72, and $43,600 before and $2,580, $1,265, and $1,100 after April 30, 2007), J-218 (receipts of $2,486, $2,688, and $2,773 before and $1,460, $11,064, and $61,837 after June 30, 2008); Tr. 672, 678, 722-24, 1394-95. The conclusions from the testing were variously stated in the work papers as that inventory was “properly stated at” April 30 and June 30 (Ex. J-55 at 1, 2); that inventory had been “received and entered in the proper period” (Ex. J-155 at 1; Ex. J-218 at 1, 3); and that “inventory cutoff controls were in place and operating effectively” at April 30 (Ex. J-121 at 2, 4; Ex. J-217 at 1, 3).

Also, a notation on the 2006 inventory audit program stated, “GT reviewed the goods received during the last week of June and noted nothing unusual.” Ex. J-54 at 3.

[22/] In each audit, the ratio analysis work paper did not explain why the current-year June 30 inventory balance used in the procedure ($12,023,106, $9,928,786, $9,374,344) differed from the respective June 30 balance used in the inventory rollforward ($9.6 million, $9.1 million, $8.7 million), or, as to 2006 and 2007, from the respective financial statement balance ($10,522,605, $9,923,544). *Compare* Exs. J-57 at 1, J-156 at 1, J-252 at 1 (Koeppel signed off) *with* Exs. J-33 at 5, J-127 at 2 (Koeppel signed off), J-222 at 5 (same) *with* Exs. J-59 at 27 & J-172 at 28 (Koss Forms 10-K).

V.

We turn to the disposition of the charges before us. The Division bears the burden of proving by a preponderance of the evidence that Koeppel engaged in an act or practice, or omitted to act, in violation of PCAOB rules and auditing standards, as charged in this case. PCAOB Rule 5204(a); *see* Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. 7215(c)(4); PCAOB Rule 5300(a). Our findings are based on a *de novo* review of the record. PCAOB Rules 5460(c), 5465. We apply PCAOB rules and auditing standards as they existed at the time of the alleged violations.

A. Koeppel's Liability As Auditor With Final Responsibility For The Audits

As a threshold matter, we address Koeppel's contention that, even taking the Division's factual allegations as true, those allegations cannot support a finding that she, as the auditor with final responsibility for the audits, violated the specific PCAOB rules and auditing standards with which she is charged in the OIP. We reject her argument, and hold that the allegations, if proven, would support a finding that she violated the rules and standards charged.

The Division alleges that in each audit in question, Koeppel, the auditor with final responsibility for the audit, knew facts about the procedures performed and evidence obtained that would give rise to violations of PCAOB Rules 3100 and 3200T and various PCAOB auditing standards, as summarized in Section III above. The Division alleges, as a factual matter, that Koeppel did not direct audit assistants to take corrective action. And it alleges that she omitted to perform herself the additional audit work necessary to provide sufficient competent evidential matter to obtain reasonable assurance about whether the financial statements were free of material misstatement and thus support the unqualified audit opinion she developed and authorized to be issued.

Specifically, it is undisputed that Koeppel was the auditor with final responsibility for the audits of Koss's financial statements for the fiscal years ending June 30, 2006, 2007, and 2008, and that she authorized the issuance of Grant Thornton's unqualified audit opinions on those financial statements. The Division alleges that, in all respects relevant to this case, through work paper review or otherwise, Koeppel "was aware of the nature and extent of the procedures performed and evidence obtained in each of the charged audit areas" when she formed that year's audit opinion. *E.g.*, DOB 1, 2 n.3, 4, 6; DRB 3, 4; DPet. 9; OIP ¶¶ 5, 20, 27 & n.2, 30, 34, 39, 40, 43, 45, 47, 49, 53, 59, 60, 61, 68, 74, 75, 79. Yet, the Division further alleges, she "failed to obtain the evidential matter or reasonable assurance required under the standards" to support the opinion (*see* AU §§ 110, 326). *E.g.*, DOB 2-3, 4, 7; DPet. 3; OIP ¶¶ 81(b)-(c). And, it alleges, certain presumptively mandatory responsibilities, which PCAOB standards state "should" have been carried out in the audit, were not, nor is there evidence that their objectives were still achieved through alternative actions (*see* PCAOB Rule 3101(a)(2)).

Those responsibilities consisted of: (1) selecting from Koss's general ledger journal entries to be tested (*see* AU § 316.61); (2) obtaining evidence and performing procedures concerning the accuracy and completeness of data generated by Koss's information system where internal controls were not tested (*see* AU §§ 319.65, 329.16); (3) developing expectations for analytical procedures used as substantive tests that were precise enough to provide the desired level of assurance that differences between the expectations and recorded amounts that might be potential material misstatements would be identified for investigation (*see* AU § 329.17) and documenting the evaluation of significant unexpected differences (*see* AU § 329.22); and (4) applying substantive tests to provide a reasonable basis for extending to the balance sheet date the audit conclusions relative to certain assertions tested at the interim date (*see* AU § 313.08). *E.g.*, DOB 4, 6-7; OIP ¶¶ 29, 43, 50, 57, 71-72, 78-79, 81(d)-(h).

The Division concludes that Koeppel, knowing the pertinent state of the audit work at the time, "is liable because she formed an audit opinion without performing presumptively mandatory procedures" and "failed to obtain the required evidence or assurance," having not assigned anyone else to perform additional procedures or obtain additional evidence and assurance. *E.g.*, DOB 2-3, 4, 6, 34; DRB 3, 13; DPet. 9-10; DPHS 88-89; *see, e.g.,* OIP ¶¶ 5, 7-8, 27-29, 41-43, 47-50, 52, 54, 57, 69, 71-72, 77-79. In particular, the Division asserts that, due to these alleged acts and omissions, Koeppel failed to obtain reasonable assurance and sufficient competent evidential matter, as required by AU §§ 110, 150, and 326; failed to comply with AU §§ 313, 316, and 329; and failed to exercise due professional care, including professional skepticism, as required by AU §§ 150 and 230. *E.g.*, DOB 2-3, 7, 28-30, 34; DPet. 7-9; OIP ¶¶ 80-81.

Koeppel, relying heavily on the initial decision, urges us to hold, as the hearing officer did, that the Division "failed to establish a cognizable basis for imposing disciplinary sanctions on Koeppel" (I.D. 83, 85). KOB 1. Essentially, Koeppel argues that the Division "expressly disclaimed" reliance on PCAOB standards that "address[ed] her conduct in the roles she actually performed" (I.D. 79-83) and instead asserted grounds of liability that were inapplicable or invalid. KOB 2, 3-4, 21, 31-35.

According to Koeppel, the functions she performed as the auditor with final responsibility for the audits in question included planning and delegating the audit work, "review[ing] selected workpapers in critical audit areas," and "determin[ing] in her judgment that appropriate work had been performed to support the issuance of the audit opinion[s]," but not otherwise personally performing the field work. KOB 12, 20, 31-32; *see* I.D. 76; Tr. 747, 1193. Koeppel concurs with the initial decision's assessment that she "assigned responsibility for performing the audit procedures, including obtaining evidential matter, to the other members of the engagement teams" (I.D. 82). KOB 21, 32-33. Although Koeppel surely shaped the overall field work through her involvement in planning and supervising the audits (*see, e.g.*, Tr. 180-81, 184-85, 276, 376-78, 686, 1237-38, 1242, 1244, 1267), the Division acknowledges that "[a]s is typical in larger firm audits, team members (other than Koeppel) performed tests of details and analytical procedures, collected audit evidence, and drafted and reviewed work papers documenting this work." DOB 7; *see* DOB 1, 27-28, 29; DRB 1, 2-3.

Koeppel, like the initial decision, submits that audit planning and supervision are obligations that PCAOB auditing standards "distinct[ly]" (I.D. 77) impose on the auditor with final responsibility for the audit (KOB 6, 35; *see* I.D. 77, citing AU §§ 150.02, 230.06, and 311), and states that these standards "clearly permit [that auditor] to delegate the performance of audit procedures" (KOB 7; *see* I.D. 76, citing AU § 311.02). In this regard, Koeppel argues that the other field work standards refer generally to "the auditor" (*e.g.*, AU § 326.25) and so do not "assign specific responsibilities" to perform audit procedures to the auditor with final responsibility for the audit. KOB 5-6, 7, citing PCAOB Standing Advisory Group Meeting, Panel Discussion – Engagement Team Performance, at 1 (June 21, 2007) (Board interim auditing standards "do not provide direction as to which members of the engagement team have the responsibility to perform the auditing procedures"). Yet in this case the Division "elected not to rely on th[e] standards" governing planning, delegation, or supervision (I.D. 78, 80, 81), as the Division has acknowledged (DRB 4 n.13; DPHR 4; Tr. 2358-59). KOB 2, 12, 33, 34, 35.

Drawing these threads of argument together, Koeppel takes the position that the charges in this case, including failure to exercise due care, are "based on Koeppel's performance of her responsibilities in reviewing workpapers prepared by others," which is a "supervisory responsibility under AU § 311," and therefore, unlike here, the charges could only be validly asserted as or with an AU § 311 charge or, if not so stated, would at least have to be "place[d]" implicitly "within the context of the engagement partner's responsibilities to plan and supervise the audit." KOB 12, 32-33, 34-35; *see* I.D. 79 n.29, 81-82. To hold otherwise, she claims, would "erase" or "obfuscate" the "difference between performing audit procedures and supervising the performance of those procedures" and ignore "the professional judgments exercised by the engagement partner in performing her supervisory responsibilities under AU 311." KOB 7-8, 32-33.

Additionally, Koeppel argues that, to the extent the Division advocates what the initial decision called "a broad standard requiring an engagement partner to 'ensure' that all members of the engagement team comply with PCAOB auditing standards during an audit" (I.D. 79-80), there is no valid basis for such a theory of violation. According to Koeppel, it would constitute strict or vicarious liability, "[i]mputing conduct by individual engagement team members to the engagement partner" "without consideration of the facts and circumstances of the engagement partner's conduct"; would "effectively eliminate th[e] element of professional judgment" exercised by the engagement partner; would "eviscerate the protections afforded to supervisory personnel by section 105(c)(6) of the Sarbanes-Oxley Act," 15 U.S.C. 7215(c)(6); and would be untenable under existing authority. KOB 3, 7-9, 31-32, 33-34; *see* I.D. 10-11, 78-83, 84-85.

After careful consideration of the parties' arguments and applicable authority, we conclude that the Division has set forth a cognizable basis for finding violations and imposing sanctions against Koeppel. The charges before us against Koeppel are validly grounded in application of basic principles to the case as alleged by the Division.

The Board may sanction a registered public accounting firm or an associated person of the firm if the Board finds, based on all of the facts and circumstances, that the firm or individual "has engaged in any act or practice," or "omitted to act," in violation of certain statutes, rules, and standards, including the rules of the Board and professional standards. Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. 7215(c)(4). PCAOB Rule 3100 states that the firm and its associated persons shall comply with all applicable auditing and related professional practice standards. PCAOB Rule 3200T specifies the auditing standards with which such firm and persons shall comply in connection with the preparation or issuance of any issuer audit report (*see* Rule 1001(a)(vi)). Accordingly, such firm and persons must comply with PCAOB auditing standards in the planning, conduct, and reporting of the results of an audit of issuer financial statements. *See, e.g.,* AU §§ 110.01, 150.01, 230.02.

PCAOB auditing standards use the term "auditor" to refer to the audit firm and its associated persons, unless the context otherwise requires. *See, e.g.,* PCAOB Rule 1001(a)(xii) (when used in PCAOB rules, unless the context otherwise requires, "The term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."); Rule 3101 (addressing certain terminology used to describe the degree of responsibility, such as presumptively mandatory responsibility, imposed on "auditors" by the Board's auditing and related professional practice standards, including the interim standards adopted in Rule 3200T); AU § 201.01 ("[t]he general standards are personal in nature"); AU § 230.02 ("each professional within an independent auditor's organization" is responsible for observing the standards of field work and reporting); AU § 210.03 (individual audit firm personnel "must meet the responsibilities attaching to the varying gradations and functions of their work"). Under the standards, the auditor is responsible for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. AU § 110.02. In conducting the audit, the auditor is required to exercise due professional care, including professional skepticism. AU §§ 150.02, 230. Due professional care "imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting." AU § 230.02. The third standard of field work requires the auditor to obtain sufficient competent evidential matter concerning the assertions in the financial statements under audit to afford a reasonable basis for any opinion the auditor develops regarding the financial statements. *E.g.*, AU §§ 150.02, 230.11, 326.22, 326.25. Most of the auditor's work in forming an opinion consists of obtaining and evaluating evidential matter concerning those assertions. AU § 326.02. Auditing procedures are acts the auditor performs during the course of the audit to comply with auditing standards. AU § 150.01.

A firm has an obligation, in connection with work on a particular audit, to assign to the audit an engagement partner with sufficient knowledge of the relevant professional standards and of the client. AU § 230.06. This individual, the auditor with final responsibility for the audit, personally performs the audit work necessary to support any audit opinion that would be issued or assigns a portion of the work to other firm personnel, subject to PCAOB auditing standards, and performs the rest. *See, e.g.*, AU §§ 150.02 ("The work is to be adequately planned and assistants, if any, are to be properly supervised.") (emphasis added), 230.06 ("The auditor with final responsibility is responsible for the assignment of tasks to, and supervision of, assistants."), 311.02 ("The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel."; all firm personnel other than that auditor are referred to as assistants, for purposes of AU § 311, *Planning and Supervision*) (emphasis added); *Gregory M. Dearlove, CPA*, SEC Rel. No. 2779, 2008 WL 281105 (Jan. 31, 2008), *10 (engagement partner "did not pursue, or direct his team to pursue," the "reason behind the dramatic reduction in [the audit client's] net receivable balance"), *16 (he "did not confirm, nor ask his team to confirm, that the assets were actually available for application against the co-borrowed debt as well as unencumbered"), *27 (he "had a duty to inquire in more detail about the direct placements, or to direct his staff to do so"). Where the auditor with final responsibility for the audit fails to do either one, he or she may be charged with violating various PCAOB auditing standards, such as those governing planning, delegation, supervision, and/or performance of audit work. *See, e.g., Dearlove*, 2008 WL 281105, *4, *10 & n.41 (as to one audit area, finding that engagement partner violated AU §§ 230.07-.08, 312.17, 316.27, 326.22 & 334.09, as well as supervision standard AU §§ 311.01, 311.11), *17 & nn.60-61 (as to a separate audit area, finding that he violated AU §§ 230.01, 230.07-.08, 312.17, 333.02 & 334.09, not including supervision standard).

This rule of decision, repeatedly invoked by the Commission in *Dearlove*, is firmly grounded in PCAOB auditing standards, which vest the engagement partner with responsibility for the use of audit assistants and with a continuing responsibility as the auditor with "final responsibility" for the audit. It is a ground for decision of this case, as alleged, that encompasses not only the assignment of audit procedures, but alternatively their performance, by the auditor with final responsibility for the audit. Thus, as pertinent here, that auditor must act with due care to see that the audit team—of which he or she is a "key member[]" (*see, e.g.*, AU § 316.14, .17)—performs all of the audit procedures that are required under the circumstances by PCAOB auditing standards, obtains reasonable assurance that the financial statements under audit are free of material misstatement, and obtains sufficient competent evidential matter to afford a reasonable basis for the audit opinion.

Koeppel's reductionist, binary approach, in which an engagement partner either performs detailed audit procedures in the first instance or has nothing but a supervisory role to play in the audit, ignores that "auditing in fact involves a continuous process of gathering, updating, and analyzing information throughout the audit" (AU § 316.03) and that the partner has the capacity and responsibility to act in multiple roles, if necessary. Inert passivity in the face of known facts constituting shortcomings in the audit does not insulate the partner from liability, simply because that inaction might be viewed, but is not charged, as deficient supervision. It need not be. As the auditor with final responsibility, it was Koeppel's responsibility to follow up on such matters either by directing her assistants to address them or by doing so herself. As the Division argues, "the allegations in the OIP that Koeppel failed to obtain the required evidence or assurance herself or ensure that procedures were performed to obtain such evidence" are consistent with the Commission's holding in *Dearlove* that the engagement partner in that case "directly violated various [auditing] standards when he had failed to perform necessary audit procedures himself or ask his team to perform the procedures to obtain the required audit evidence." DPet. 9-10; *see, e.g.*, DOB 30-31, DPHS 88-89.

The initial decision was thus incorrect in narrowly describing the "SEC decision" as "rest[ing] on the supervisory responsibilities of an engagement partner" (I.D. 79). That description ignores the larger principle that omitting to act in the face of known facts requiring action before forming an audit opinion and authorizing the issuance of an audit report subjects the auditor with final responsibility for the audit to direct liability for auditing standards violations. If, as alleged here, that auditor did not respond to those facts by assignment and supervision of further audit work to address the deficiencies, then she was responsible for herself performing the additional audit work necessary to support the opinion. It makes no difference that, in the first instance, she had "assigned responsibility for performing the audit procedures, including obtaining evidential matter, to the other members of the engagement team[]" (I.D. 82). As the Division correctly points out, "Adequate audit planning and supervision of assistants is a means to the objective of obtaining sufficient competent evidence on which to base an audit opinion. It does not replace that objective, and is not the exclusive standard that must be followed by engagement partners in conducting public company audits, regardless of whether they delegate work to assistants." DRB 3-4. Another means is for the engagement partner to perform necessary additional audit work himself or herself. By whatever means, that auditor needs to take action to address the deficiencies.

Koeppel's suggestion (*e.g.*, KOB 32-33) that the text of AU § 311, which makes particular reference to the auditor with final responsibility, essentially exhausts the obligations of that auditor, at least one who has at one time acted as a supervisor in the audit, lacks support in AU § 311 itself. Paragraphs 11, 12, 13, and 14 refer to "directing the efforts of assistants"; "direct[ing]" assistants to "bring [significant accounting and auditing questions raised during the audit] to [the] attention" of the auditor with final responsibility and "assess[ing] [the] significance" of those questions; "reviewing the work performed" by each assistant "to determine whether the results are consistent with the conclusions to be presented in the auditor's report"; "determining whether [the audit] objectives were accomplished"; and "dealing with differences of opinion among firm personnel" with a view toward "resolution of the matter." But AU § 311 does not specify what the supervisor is supposed to do if, after undertaking these tasks, the objectives are not accomplished and the results would not be consistent with the report. Other standards bear on those matters. *E.g.*, AU §§ 312.02 n.3, .38, 326.25. Similarly, AU § 311.11 refers to "the objectives of the audit," but it does not specify those objectives. Other standards describe audit objectives. *E.g.,* AU §§ 110.01, 230.11, 326.09-.13, .22, & .25. And AU § 311.13 refers to "the conclusions to be presented in the auditor's report" without specifying how those conclusions are formed or developed.[23/]

In passages of the initial decision cited and quoted by Koeppel (KOB 2), the hearing officer stated that the Division had "made no effort to prove that Koeppel, herself, performed any audit work that violated PCAOB auditing standards, but rather focused on the work of the other engagement team[] members, noting, where applicable, evidence of Koeppel's general awareness of that work in her supervisory role," and stated that "I have never presided over, or reviewed, a case in which prosecuting counsel offered so little evidence regarding the conduct of a respondent." I.D. 78, 79. These statements reflect no recognition that actionable conduct can consist of "omit[ting] to act" in the face of facts requiring action. *See* 15 U.S.C. 7215(c)(4). Nor do they recognize the role played in this case by the evidence of the audit planning and work paper reviews. The Division used that evidence to try to establish the factual context in which its theory of violation operates by showing Koeppel's knowledge of the state of the audit work. Indeed, at one point, the initial decision acknowledged that Koeppel "has never denied having overall responsibility for the Relevant Audits," noted that the Division identified "many" "relevant work papers that she had reviewed," and cited examples of key facts underlying the charges that "she admits that she was aware of." *E.g.,* I.D. 79 n.29, 83, 84. Koeppel herself noted that she "testified over the course of three days about the work she performed." KPHS 5. But in the end the initial decision instead viewed the planning work and the work paper reviews as the theory of violation itself, consisting of an uncharged planning or supervision theory, because planning and review are "responsibilities under [AU § 311]," and thereby mistakenly treated that evidence as if it could only be relevant to charges not made here. I.D. 79.

Similarly, it reflects neither a proper description of the charges against Koeppel nor a proper effort at analysis of the particular facts of the case to suggest, as Koeppel does (KOB 12, 21), that the case cannot proceed without a general rule provided by an expert witness about how an engagement partner is supposed to supervise an audit. The case does not depend upon whether the Division and its expert "address[ed] the

[23/] The PCAOB staff paper cited by Koeppel's brief (PCAOB Standing Advisory Group Meeting, Panel Discussion – Engagement Team Performance (June 21, 2007)) is of no assistance to her argument. Rather than stating that PCAOB auditing standards phrased in terms of "the auditor" cannot specifically apply to the auditor with final responsibility, as she implies (KOB 6), the paper states (p. 6) that "the auditing standards generally direct the auditor, who can be either the audit partner [*i.e.*, the auditor with final responsibility for the audit] or another member of the engagement team, to perform a specific audit procedure."

level of oversight" in reviewing others' audit work that "Koeppel was required to exercise in her role as the engagement partner" or "the extent to which an engagement partner, exercising due professional care" in a supervisory review, "should have identified" certain alleged facts about the work (I.D. 83, 84, cited by Koeppel)—facts that in at least some instances she admits to having known and that in the others might be apparent or reasonably inferred from the record. Likewise missing the mark is her argument that the charges here "effectively eliminate the engagement partner's ability to delegate portions of the supervision of the audit." *See* KOB 4, 8, 20-21, 32. The Division asserts a theory of violation based on Koeppel's fundamental, non-delegable responsibility as the auditor with final responsibility for the audits and her awareness of certain facts about the audit work. This is not a supervision theory, and if, as the Division contends, it has proven that Koeppel knew those facts, then the Division makes a compelling logical argument that whether she learned them "through a 'first-level review,' a 'second-level review,' or some other method is irrelevant" (DRB 4). If the Division did not prove that she was aware of those facts, then that is a failure of proof, not the lack of a cognizable theory.

For those and other reasons, there is no merit to Koeppel's additional contention that the Division's position would "eviscerate the protections afforded to supervisory personnel" under Sarbanes-Oxley Act Section 105(c)(6). Again, the Division is not asserting a supervision theory. As the Division correctly argues, Section 105(c)(6) "creates a new ground of liability" and "does not purport to limit liability under long-established auditing standards charged here, such as AU §§ 230 and 326," or purport to limit the Board's broad authority provided in Section 105(c)(4) to impose sanctions for all violations of PCAOB rules or standards. DRB 3-4 n. 13; *see* PCAOB Rel. No. 2010-005 at 1-10 (Aug. 5, 2010). In any event, Koeppel has not asserted an affirmative defense under Section 105(c)(6)(B), and the theory the Division advances is inherently incompatible with satisfaction of the statutory conditions for that affirmative defense.

Finally, contrary to Koeppel's claims (KOB 8-9 & n.5, 31, 32, 33), this case is not about strict or vicarious liability, under which sanctions could be imposed on her for an act, practice, or omission of someone else, irrespective of the circumstances of her own conduct. As she notes, the initial decision construed the Division's citation of certain language in the OIP and in SEC and PCAOB settled orders as taking the positions that an engagement partner is "required to either perform the audit work herself or 'ensure' that the engagement teams' work conformed to PCAOB auditing standards" and that the "ensure" phrasing means "imposing disciplinary sanctions on a respondent based on the imputed conduct of others" (I.D. 78-80, 87). KOB 31-32. But the Division has repeatedly stated that the charges against Koeppel are based on her own conduct. *See, e.g.*, DOB 2, 4; DRB 3; DPet 3; DPHS 1-4; DPHR 3, 27 n.40, 51-57. Thus, we read the Division's citations to the "ensure" part of the quoted formulation as simply referring to the uncontested fact that Koeppel made no effort to address the allegedly evident facts giving rise to the violations through assignment and supervision of additional audit work. Nor did she personally perform the additional work required to support the audit opinion. The overall point is that she took no corrective action of any kind in response to the facts about the audit work the Division alleges were known to her. We hold that her role as the auditor with final responsibility for the audits does not have the effect of insulating her from a finding that she violated the specific rules and standards charged in the OIP if the evidence establishes the facts alleged in the OIP.

B. Analysis of the Evidence of Koeppel's Alleged Violations

The ultimate matter for decision, then, is whether the Division proved by a preponderance of the evidence that in the 2006, 2007, and 2008 Koss audits, Koeppel, the auditor with final responsibility for the audits, violated PCAOB auditing standards, as charged, by omitting to perform audit work necessary to comply with those standards. There is no dispute that in each of those audits Koeppel ultimately accepted the work performed and results obtained in the charged audit areas as adequately performed and sufficient to support the unqualified opinions she developed and authorized to be issued. We address below whether, in fact, those procedures were adequately performed and those results were sufficient, and, if not, whether the facts known to Koeppel at the time put her on notice of that. We do so against the backdrop of applicable PCAOB auditing standards and certain decisions Koeppel made or approved in leading the audits that affected the performance and results of the work.

The standards require that audits be planned and conducted to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. AU § 110.02; *see* Tr. 772, 850 (Koeppel); Exs. J-65 at 1, J-173 at 2, J-276 at 1. Under the standards, the auditor obtains an understanding of the entity's internal control and uses that understanding and consideration of audit risk and materiality in determining the nature, timing, and extent of the audit procedures. *E.g.*, AU §§ 312.01, .12, 319.05.

Specifically, the auditor is required to obtain an understanding of the entity's internal control sufficient to plan the audit, which includes determining whether controls that are likely to prevent or detect material misstatements in financial statement assertions have been placed in operation. *E.g.*, AU §§ 319.01 (citing AU § 150.02 (second standard of field work)), .02, .14, .27, 316.44-.45, .60. In the process, the auditor should obtain knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and should consider the methods it uses to process accounting information and prepare financial statements, such as its IT system, and how they may affect relevant controls. *E.g.*, AU §§ 319.02, .25, .27, .29, .30, .43-.47, .51, .58, 316.43, .44, .58 & n.23, .60, 311.06, .07, .09. The objective of those procedures is to provide knowledge necessary for audit planning. AU § 319.84. The auditor uses such information to, for example, identify types of potential misstatement, consider factors that affect the risk of material misstatement, and design substantive tests. *E.g.*, AU §§ 150.02 ("A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed."), 319.01, .02, .05, .25, .29, .71, .106, 316.43, .47, 312.16, 311.05.

The auditor is also required to consider audit risk and materiality in determining the nature, timing, and extent of audit procedures. AU §§ 312.01, .12. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated. *E.g.*, AU §§ 312.02, .27, 319.63, 319.105.

Under PCAOB standards, the auditor, in planning the audit, should consider the three general components of audit risk and make an assessment of the risk of material misstatement due to error or fraud. *E.g.*, AU §§ 312.02, .16, .27, 319.63, 319.105. Those components are (1) inherent risk—the susceptibility of an assertion to a material misstatement, assuming there are no related internal controls; (2) control risk—the risk that a material misstatement that could occur in an assertion would not be prevented or detected on a timely basis by the entity's internal control; and (3) detection risk—the risk that the auditor will not detect a material misstatement that exists in an assertion. *E.g.*, AU §§ 312.27, 319.63; *see* Tr. 850, 857-58, 1241, 1503. The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. AU § 319.81. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that can be accepted increases. *Id.*; *see* AU §§ 319.106, 312.28 ("Detection risk should bear an inverse relationship to inherent risk and control risk. The less the inherent and control risk the auditor believes exists, the greater the detection risk that can be accepted. Conversely, the greater the inherent and control risk the auditor believes exists, the less the detection risk that can be accepted."). The acceptable detection risk in the design of audit procedures "is based on the level to which [the auditor] seeks to restrict audit risk related to the account balance or class of transactions and on the assessment of inherent and control risks." AU § 312.32.

PCAOB standards require a specific assessment of the risk of material misstatement due to fraud. *E.g.,* AU §§ 312.16, 316; *see* Tr. 1264-65. In addition to overall responses to that risk and responses to address specifically identified fraud risks, the auditor should examine journal entries and other adjustments for evidence of possible material misstatement due to fraud to further address the risk that management might manipulate accounting records and prepare fraudulent financial statements by overriding internal controls. The additional procedures include selecting from the general ledger journal entries to be tested and examining support for those items. *E.g.*, AU §§ 316.42, .48, .51, .58, .61; *see* Exs. J-3 at 1, 3, 4, J-100 at 3, 4, 6, J-200 at 3, 4, 7; Tr. 773-79 (Koeppel); Tr. 707, 709 (2007-2008 Staff Auditor). AU § 316's repeated references to "the general ledger" in describing the required journal entry testing reflect that having a complete set of the entries is a prerequisite to the testing. *See* AU §§ 316.58 ("the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger"), .61 ("the auditor's procedures should include selecting from the general ledger journal entries to be tested"). As the initial decision noted, "Koeppel herself acknowledged that to achieve the objectives" of AU §

316.61, even if through an alternative to direct access to Koss's general ledger, "it was necessary to select journal entries from a complete population." I.D. 36 (citing Tr. 776).

Under AU § 312.13, "The auditor should plan the audit so that audit risk will be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements." *Accord, e.g.*, AU §§ 312.19 ("In planning the audit, the auditor should use his or her judgment as to the appropriately low level of audit risk and his or her preliminary judgment about materiality levels in a manner that can be expected to provide, within the inherent limitations of the auditing process, sufficient evidential matter to obtain reasonable assurance about whether the financial statements are free of material misstatement."), .26 ("The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him or her, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk."), 319.15.

The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the audit procedures to be applied to the account balance or class of transactions to detect material misstatements in the financial statement assertions. AU § 319.81; *see* AU § 319.82 ("As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase."). After considering the level to which he or she seeks to restrict the risk of material misstatement and the assessed level of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. AU § 319.106. "Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence." AU § 312.17. The evidential matter provided by the combination of the assessment of inherent risk and control risk and on substantive tests should provide a reasonable basis for the opinion regarding the financial statements under audit. AU §§ 326.13, 319.105.

Under PCAOB standards, "regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." AU §§ 319.02 & .107; *accord, e.g.*, AU §§ 316.51 ("because management may have the ability to override controls that otherwise appear to be operating effectively" it is "unlikely that audit risk can be reduced to an appropriately low level by performing only tests of controls"), 312.32 ("not appropriate," where material misstatements could exist, "to rely completely on assessments of inherent risk and control risk to the exclusion of performing substantive tests of accounts balances and classes of transactions"); *see* Tr. 861, 1021.

In the Koss audits, Koeppel considered the occurrence and net valuation of revenue and the existence of inventory to be what she described as "critical financial statement assertions." In particular, she recognized that Koss's revenue-related accounts of net sales, special sales allowances, and accounts receivable and Koss's inventory account were all material components of its financial statements and that the respective reported amounts embodied relevant financial statement assertions related to significant accounts. *See* pp. 8, 11-12; Tr. 1021; KOB 44; *see generally, e.g.,* AU §§ 319.02, .107, 326.13, .25. To Koeppel, this meant there was a reasonable possibility of material misstatement with respect to those "critical areas" and that the audits would devote "additional attention" to and "focus heavily" on them. *See* pp. 10-11 above.

With respect to the components of audit risk, Koeppel concluded in each of the Koss audits that the overall inherent risk of misstatement for those assertions was low. Koeppel chose not to test the operating effectiveness for the audit period of Koss's internal controls over those assertions or over Koss's IT system. Consequently, she assessed control risk at the maximum level and did not rely on internal control testing to reduce the substantive audit procedures required in those areas. *See* pp. 12-14, 18, 19 above. That level of control risk represented "the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by [the] entity's internal control." AU § 319.03 n.3. As summarized in Koss audit planning sessions led by her, assessment of control risk at that level "will impact necessary substantive testing to be performed through larger sample sizes or additional testing in critical areas including revenue recognition and inventory reporting." Exs. J-3 at 4 (2006), J-100 at 4 (2007).

For the substantive audit testing, a "combined medium risk" strategy developed by Grant Thornton corresponded to these risk assessments and was purportedly applied by Koeppel in the Koss audits. Ex. R-483 at 7-8; *see, e.g.,* Tr. 1438-40 (Koeppel); Ex. D-4 at 76 (Audit Manager's investigative testimony: "You've got a combination here, control risk is high, inherent is low. The combination thereof is somewhere in between."). That strategy "emphasizes analytical procedures on income statement accounts," such as net sales, and "tests of details for balance sheet accounts," such as accounts receivable and inventory. *See, e.g.*, Ex. J-60 at 20, 21.

Analytical procedures "are an important part of the audit process." AU § 329.02. A "basic premise" underlying their application is that plausible relationships among data "may reasonably be expected to exist and continue in the absence of known conditions to the contrary." *Id.* The auditor obtains assurance from analytical procedures "based upon the consistency of the recorded amounts with expectations developed from data derived from other sources." AU § 329.16. Among the factors on which the expected effectiveness and efficiency of the procedure in identifying potential misstatements depend, PCAOB auditing standards specify "the availability and reliability of the data used to develop the expectation" and "the precision of the expectation." AU § 329.11; *see* AU §§ 329.16 ("The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure."), .17 ("[t]he expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aagregated with other misstatements, would be identified for the auditor to investigate"),

.19 ("Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons.").

In addition, Koeppel adopted an approach in the Koss audits of applying principal substantive tests to the details of Koss's accounts receivable and inventory accounts as of an interim date rather than as of the balance sheet date. Where interim date audit testing is employed, substantive tests "should be designed to cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of [the] interim date, and any audit assurance provided from the assessed level of control risk, achieve the audit objectives at the balance-sheet date." AU § 313.08. As pertinent here, considerations related to designing the substantive tests to cover the remaining period "in a way that will provide a reasonable basis for extending to the balance-sheet date the audit conclusions from the tests of details at the interim date" include the "potential incremental risk" of material misstatement that may arise from testing an asset or liability account, like accounts receivable and inventory, principally at an interim date; the impact of an assessment of control risk at the maximum on the effectiveness of the remaining period tests; and the capability of the entity's accounting system to provide sufficient information for use in those tests. *See* AU §§ 313.03, .05, .07; Tr. 887-89, 892-93, 919, 937, 1088, 1479.[24/]

Further, Koeppel made the judgment that for substantive testing in the 2006, 2007, and 2008 Koss audits it was not necessary to directly access Koss's electronic general ledger, the repository of all of Koss's recorded transactions and adjustments. *See* pp. 27-29 above. PCAOB auditing standards specified that "the auditor's procedures should include selecting from the general ledger entries to be tested and examining support for those items" (AU § 316.61) and that "the auditor's substantive procedures must include reconciling the financial statements to the accounting records" (AU § 326.19). As Koeppel knew, for these purposes the auditors relied for access to Koss's general ledger on: (1) a set of binders, compiled and provided to the auditors by

[24/] In particular, the cited sections of AU § 313 together specify that applying principal substantive tests to the details of an asset or liability account as of an interim date rather than as of the balance sheet date: (1) "potentially increases the risk that misstatements may exist at the balance sheet date that will not be detected by the auditor"; (2) makes it necessary where the auditor additionally "assesses control risk at the maximum during the remaining period," to consider "whether the effectiveness of certain of the substantive tests to cover that period will be impaired"; and (3) makes it necessary for the auditor to consider whether "the [entity's] accounting system will provide information concerning the balances at the balance-sheet date and the transactions in the remaining period that is sufficient to permit investigation" of "(a) significant unusual transactions or entries (including those at or near year-end), (b) other causes of significant fluctuations, or expected fluctuations that did not occur, and (c) changes in the composition of the account balances," such that "evidential matter related to" these matters would be "sufficient for purposes of controlling audit risk."

Koss's accounting department, of "update reports," each of which reports the auditors were told was generated by Koss's IT system when a member of the department posted a journal entry or batch of journal entries to Koss's general ledger; and (2) general ledger account balance reports (trial balance reports), also provided to the auditors by Koss's accounting department, that, the auditors were told, Koss's IT system could only generate at a particular point in time. *E.g.*, Tr. 1336-37, 1457-62.

Indeed, Koeppel knew that the substantive audit work depended heavily on general ledger account balance reports and subsidiary ledger detail reports that were generated by Koss's accounting department from the company's IT system. Her overall decision that only substantive tests, not internal control testing, would be performed to restrict detection risk to an acceptable level and that information provided by Koss's IT system would be used to perform the substantive tests meant that the auditors "should obtain evidence about the accuracy and completeness of the information" (AU § 319.65) and, before using the results obtained from substantive analytical procedures, should "perform other procedures" than testing the effectiveness of internal controls "to support the completeness and accuracy of the underlying information" (AU § 329.16). *See, e.g.,* Tr. 847, 1025, 1142, 1187-88, 1339-40, 1442-43, 1498 (Koeppel).

The OIP charged that in all three audits, Koeppel failed to exercise due care and to obtain reasonable assurance or sufficient audit evidence regarding Koss's journal entries, net sales, accounts receivable, sales allowances, and inventory, along with violations of more specific auditing standards in each of those areas. The charges in the journal entry area concern the audit work performed to determine the completeness of the sets of Koss paper records from which journal entries were selected for testing. The charges in the net sales area concern the precision of the expectations and the audit work performed to determine the reliability of the data used in the analytical procedures. The charges in the accounts receivable area concern the audit work performed to determine the completeness of the report from which a sample of receivables was selected for confirmation testing at an interim date and the adequacy of audit testing of the remaining period receivables, including the audit work performed to determine the reliability of data used in that testing. The charges in the sales allowance area concern the audit work performed to determine the reliability of data used in tests of details. The charges in the inventory area concern the work performed to determine the reliability of data used in remaining period tests of details and analytical procedures.

As discussed in detail below, we find that Koeppel led audits that, in the charged areas, were characterized by the lack of a proper foundation for the substantive audit testing. By foundation, we refer to the completeness of the population of Koss's journal entries subject to testing for material misstatement due to fraud, the completeness of the population of Koss's accounts receivable subject to confirmation testing, the reliability of Koss's data used in other substantive testing of its revenue and inventory, and a basic element of the substantive analytical procedures used to test its revenue.

Repeatedly, Koeppel was willing to resolve matters she insists she took seriously, such as the completeness of the journal entry population and the reliability of Koss internal reports, in ways that accepted the company's processes and accounting records at face value. That is, despite perceived system limitations on auditor access to financial data maintained electronically by Koss, the general lack of internal control testing in the audits, and an identified control deficiency each year in one of the revenue-related areas, Koeppel placed undue reliance on the scanning or comparing to one another of Koss internal reports (from the current or prior fiscal years) to which little or no audit procedures were applied, on employee representations about how the company's systems and controls were supposed to operate, on *ad hoc*, single-point-in-time observations, and on only part of the assessed risks of material misstatement. Furthermore, as an important substantive test of Koss's revenue in each of the audits, Koeppel used analytical procedures, a fundamental element of which is an expectation concerning the recorded amount. But the net sales analytical procedures employed in the Koss audits were founded on expectations so vague that they did not provide the necessary level of assurance that potential material misstatements would be identified.

In effect, in Koeppel's conception of the 2006-2008 Koss audits, as exemplified by her own arguments in this case, audit planning activities routinely assumed the role of, rather than simply informed, substantive audit procedures, "understanding" commonly took the place of testing in the audits, and great emphasis in considering the level of audit effort was placed on "low" assessed inherent risk, instead of on inherent risk combined with assessed maximum control risk. This left serious gaps in the audit evidence each year. We find Koeppel violated numerous PCAOB auditing standards.

1. Audit work on Koss system-generated reports generally

The charges of inadequate audit work on the reliability of Koss IT system-generated reports under AU §§ 319.65 and 329.16 run through the revenue-related and inventory areas of the 2006, 2007, and 2008 audits. Concerning those charges, the parties offer largely general arguments, rather than detailed attention to the role of the particular report in the particular substantive testing in the particular audit area. We address here those general arguments and devote the detailed attention necessary to resolve the charges in the sections that follow on the work in the individual audit areas.

In large part, the parties frame their arguments around the initial decision's up-front, across-the-board holding that in each audit the evidence "was sufficient to support the completeness and accuracy of standard reports generated by Koss's IT systems as a general matter" (I.D. 49). DOB 19-28; DRB 10-12; KOB 23-31. That holding rests on what Koeppel describes as the "very broad concept" of "evidence" in AU § 326.17. KOB 25. It also rests on a series of points consisting of her understanding of Koss's internal controls, her assessment of the risk of material misstatement of the financial statements, certain other audit work, and various asserted characteristics of Koss's controls and computer system. She focuses mainly on her background understandings and observations about Koss's systems and processes, not on audit procedures applied to the reports themselves, though she does refer to comparing Koss reports to one another and, in some instances, limited tracing of entries on subledger detail reports to underlying source documents. The Division describes the series of points as "nine observations, first compiled in Koeppel's post-hearing brief," though, for the most part, she cites some reference to them in the work papers, and the Division argues that the points were not "comparable" or "roughly equivalent" to evidence that would have been obtained from testing the effectiveness of controls. DOB 19-20, DRB 11-12 n.56.

The initial decision's holding is erroneous. Koeppel claims the cited information, gleaned mostly from audit planning procedures, "counts for" something and may "be considered" for present purposes, or in the words of the initial decision "bears on" system reliability (I.D. 40). KOB 25, 27. She further claims, without clearly explaining why, that this information is "appropriate evidence" (KOB 24) and "substantial evidential matter" "about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP" (KPHS 22). The Division is correct that these claims, along with Koeppel's "focus on AU § 326.17 in isolation," do not constitute an evaluation of the "sufficiency or competency of evidence," which involves "criteria [] such as relevancy, validity, and timeliness," and is necessary to resolve the AU §§ 319.65 and 329.16 charges before us. DOB 20 (citing AU §§ 326.02, .21); *see, e.g.*, AU § 319.90 ("The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads all bear on the degree of assurance evidential matter provides.").

The context specific to each of these charges is discussed in separate sections below, and we address there, to the extent it applies, the most directly relevant item Koeppel cites—her claim to have taken an audit approach that "incorporates into" and "embeds" in "our testing various tests of reports" used in the substantive audit procedures, namely "tying back to a supporting document or doing a roll forward or tying to the general ledger [by way of a trial balance report] or tying to a subledger [report]." Tr. 1186-88, 1340, 1348-49, 1457-62. For the reasons discussed in this section, the other cited information is too shallow and limited to provide the additional evidence of reliability necessary under the circumstances.[25/]

[25/] The inadequacy of the initial decision's cursory analysis of the data reliability charges, which analysis Koeppel generally embraces, is illustrated by the fact that both Koeppel and the Division fault the hearing officer for inconsistency when, relying on general characteristics of Koss's IT system, he declared at one point that sufficient audit evidence was obtained "to support the completeness and accuracy of standard reports generated by Koss's IT systems as a general matter" (I.D. 43, 49) yet at another declared that the audit evidence about the reliability of a particular report was insufficient (I.D. 49-50). *See* DOB 14 & n.58, 18-19, 23; KOB 29 n.19; KRB 2, 12.

The audit work at issue on data reliability was integral to the substantive audit testing itself, which was all that was used in the Koss audits to restrict detection risk to an acceptable level for the "critical" areas of revenue and inventory (*see* p. 14 above). By its terms, the requirement in AU § 319.65 to obtain evidence about accuracy and completeness applies to information from an entity's information system that is used by the auditor to perform "substantive tests," where the auditor is performing "only substantive tests in restricting detection risk to an acceptable level," and the requirement in AU § 329.16 to "perform other procedures" to support completeness and accuracy applies to entity financial information "underlying" "substantive analytical procedures," where, likewise, the auditor does not "test the design and operating effectiveness of controls" over that information. And these charges before us are asserted in conjunction with AU § 326, which sets forth the auditor's objective "to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion," and AU § 313, which concerns substantive audit tests "that are necessary to cover the remaining period in a way that will provide the appropriate audit assurance at the balance-sheet date." *See, e.g.*, OIP 11 ¶ 32, 12 ¶ 37, 13-14 ¶¶ 41-43, 15-16 ¶¶ 51, 54, 17 ¶ 57, 19-20 ¶¶ 67, 69, 71-72, 21-22 ¶¶ 77-79, 81(b), (e), (f). The performance of procedures and collection of evidence to determine the reliability of system information must be commensurate with the role of the information in the audit.

As AU § 326.16 makes clear, "without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on the financial statements would not be warranted." Financial reports produced by Koss's information system were merely representations of the underlying accounting data. In the Koss audits in question, those reports were a snapshot, which Koeppel understood could only be generated at a specific point in time, of Koss's subsidiary and general ledgers, which existed only in electronic form. She understood that data that accumulated in the subledgers had to be transferred monthly to the general ledger by journal entries initiated by Koss's accounting department and that the department could also post journal entries directly to the general ledger, bypassing the subledgers. *See* p. 21 above. The only access obtained to Koss's journal entries in the three audits was through binders of paper forms and Koss IT system-generated "update reports." Given that journal entries recorded in the system could affect the content of system-generated reports and alter the data reflected in them, such restricted access was not helpful to the audit work that, under PCAOB standards, "must" be performed to "reconcil[e] the financial statements to the accounting records" (AU § 326.19; *see* Tr. 883).

Audit testing of the design and operating effectiveness of an entity's internal control over the financial information generated by its IT system, or performing other audit procedures and obtaining audit evidence concerning the completeness and accuracy of that information, establishes a relationship between the system reports and the underlying data that helps guard against reliance in substantive audit testing on information that, for example, has been entered incorrectly on a large scale by entity personnel, captured, summarized, or reported incorrectly by its computer system, or manipulated by fraudulent entries or omissions. *See, e.g.*, AU §§ 312.06 (unintentional misstatements or omissions of amounts in financial statements may involve "[m]istakes in gathering or processing data from which financial statements are prepared"), 316.06 (fraudulent financial reporting may be accomplished by, among other things, "[m]anipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared" or "[m]isrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information"), 319.19 (the specific risks IT may pose to an entity's internal control include "[r]eliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both," "[f]ailure to make necessary changes to system or programs," and "[p]otential loss of data"), 319.30 (IT presents risks such as that "improperly authorized, incorrectly defined, or improperly implemented changes to the systems or programs performing the calculations, or to related program tables or master files, could result in consistently performing those calculations inaccurately"). All of this highlights the importance in the audits in question—in which the operating effectiveness of internal controls over IT and critical assertions was not tested, in which Koss's electronic database was not viewed for the significant substantive evidence it contained, and in which the only window accessed by the auditors into the journal entries affecting that database was paper binders—of the procedures and evidence about the reliability of IT system-generated information used in the charged audit areas.

Koeppel's general arguments about the reliability of Koss's system-generated reports, except for the claim we address below in the sections on individual audit areas, are based on tasks performed and information obtained in planning the Koss audits. Of the eight of her points covered in this section, we first address her broad arguments about what she calls the "thorough understanding of Koss's controls over financial reporting, governance, revenue cycle procedures, and inventory cycle procedures" and "an extensive risk assessment process" in the Koss audits (KOB 13, 24, 28). Then we turn to her more particular other six points, which she says were the product of "an understanding of Koss's IT system" gained in the audits "as part of the procedures undertaken to obtain an understanding of Koss's internal controls" (KOB 24, 28-29).

As to understanding of internal control, Koeppel has contended that "for the purposes of a financial statement audit," by contrast to "an internal controls audit," an understanding of Koss's financial reporting system and related controls, obtained through audit team inquiry, observation, and walkthrough procedures performed for audit planning, "establish[ed] a baseline" and "provided good evidence to us" in terms of "audit support related to that a system is operating effectively." Tr. 1292-94, 1297-99, 1466-67, 1469-70. In Koeppel's view, based on that work, she "could certainly come to the conclusion" that Koss's internal controls "were designed and operating effectively," that Koss "had an internal control process" over IT that "was designed and operating effectively," and that its IT system could reasonably be relied upon in the performance of the audits. Tr. 1468-73. This was so, according to Koeppel, "not for th[e] purpose" of assessing or reducing the level of control risk but "for the purpose of determining whether or not I needed to modify my audit approach for deficiencies in the control system that would be identified during that process [of audit planning]." Tr. 1471.

Koeppel testified that, in her view, Koss had a "well-controlled process" or a "strong control environment" of "segregation of duties and the access controls that existed," as well as "monitoring controls that went on as it related to the overall financial reporting process and the active involvement by management," referring to President/CEO and VP-Finance, such that the controls were "actually working and in place" and "effective" and that "we did not need to modify our nature, scope or timing of our work." Tr. 1141-42, 1197, 1221-22, 1287-1294, 1296-99, 1305, 1311, 1328, 1334, 1387-88, 1451, 1471-73, 1493-94. She reasoned, "If I had identified that they were not operating effectively, then I would have identified control gaps or deficiencies that would have been run through the summary of control findings, and I would have needed to use that to modify my audit approach." Tr. 1469; *see* Tr. 1288, 1309-11, 1472-73. According to Koeppel, "we did not identify any issues with Koss's IT system," meaning that "it was working effectively and that it could be reasonably relied on, and that we did not need to expand our procedures beyond those that are customary." Tr. 1291-92; *see* Tr. 1288-90 (she sought in the audit planning process to "identify whether there are any issues, gaps or deficiencies in [Koss's] internal control environment that we need to take into consideration and adjust the work programs to address any control deficiencies that were noted" and to "validate our understanding of the control environment"), 1342 ("our walk-throughs validated our understanding of the system and demonstrated that it was operating effectively"), 1472-73; *see also* Ex. D-4 at 55 (in investigative testimony, Audit Manager suggested the walkthroughs "corroborated" Koss's claimed controls).

Koeppel's arguments based on her professedly "thorough understanding" of Koss's internal control (KOB 28) overstate the value of that information as evidential matter in, and understate the audit procedures and evidence necessary to, determining the reliability of the IT system-generated data at issue. As noted, understanding internal control is part of planning any audit governed by PCAOB standards. Representations from Koss personnel about how Koss's accounting and IT systems were supposed to work does not mean they actually worked that way. And as AU § 319.27 states, "Whether a control has been placed in operation at a point in time is different from its operating effectiveness over a period of time." *See, e.g.,* AU §§ 319.94 ("the observed application of a control might not be performed in the same manner when the auditor is not present"), .100 ("an observation is pertinent only at the point in time at which it is made"), 316.62 (material misstatements due to fraud "can occur throughout the period and may involve extensive efforts to conceal how it is accomplished").[26/]

[26/] Koeppel does not contest that a control being placed in operation at a point in time is different from its operating effectiveness over a period of time. Tr. 851. AU § 319.96 contains an instructive discussion of this issue, using the word "test" throughout (again, internal control was not even tested in the audits in question):

In discussing her understanding, Koeppel repeatedly uses the language of control testing ("operating effectively") and refers to the nature, timing, and extent of substantive testing, as if to imply she was entitled to reduce substantive testing that would otherwise be necessary, and with it audit work on data reliability, based solely on her understanding. To the extent that Koeppel, in her arguments in this case, treats an understanding of entity systems and controls not only as informing the design of substantive audit tests but also as itself becoming a substantive test, or a test of control effectiveness, that reduces the audit effort otherwise necessary for substantive testing, and in turn the support necessary for the completeness and accuracy of entity reports used in that testing, she is incorrect.

PCAOB auditing standards provide conditions and criteria for reducing otherwise necessary substantive testing, and this involves reducing control risk below the maximum through testing the operating effectiveness of the controls over the audit period. *E.g.*, AU §§ 319.03 (where it would be effective and more efficient than performing only substantive tests, or where it would not be practical or possible to do that, the auditor "should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk"), .76 ("Tests of controls directed toward the operating effectiveness of a control are concerned with how the control (whether manual or automated) was applied, the consistency with which it was applied during the audit period, and by whom it was applied."), .86 (procedures performed to obtain an understanding of internal control "are not sufficient to support an assessed level of control risk below the maximum level if

> The timeliness of the evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of controls for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement those tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for an application control performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the control is operating effectively at that point in time. The auditor may then perform tests of controls directed toward obtaining evidential matter about whether the application control operated consistently during the audit period, such as tests of general controls pertaining to the modification and use of that computer program during the audit period.

they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a control relevant to an assertion"), .88, .90 ("Evidential matter varies substantially in the assurance it provides to the auditor as he or she develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads all bear on the degree of assurance evidential matter provides."), .94, .96, .97, .100, .105-.107, 316.61, 312.30-.31. This instruction applies without regard to the reason controls might not be tested in any given case (*see, e.g.*, AU §§ 319.65-.69, 312.30), as Grant Thornton audit guidance recognized (*see* Ex. R-483 at 4 (June 2, 2006 firm bulletin to its auditors: "If controls are not tested or if controls are tested and not operating effectively, control risk must be assessed as High for the assertion.")).

Yet Koeppel admits that in the Koss audits internal controls were not tested or relied on to reduce the substantive audit work to be done. *E.g.*, Tr. 1287; KOB 13 (Koeppel "elected not to test or rely on Koss's internal controls in order to reduce the amount of substantive testing to be performed"); KPHS 12. Specifically, by her own account, she chose not to test the operating effectiveness for the audit period of internal controls over IT and critical assertions, she set control risk at the maximum, and she directed all of the effort in audit testing into "audit[ing] the output" of Koss's IT system, "rather than the system itself," using "a lot" of Koss reports. *E.g.*, Tr. 1254 ("we performed substantive tests rather than rely on controls"), 1336-37, 1468, 1473. As the work papers stated, "Control risk for critical cycles has been assessed at HIGH" and "GT has not placed reliance on those controls, nor did we perform any testing of said controls." Exs. J-3 at 4 (2006), J-100 at 4 (2007); *see* Ex. J-200 at 4 (2008).[27/]

For Koeppel then to say PCAOB auditing standards "do not require an auditor who is not relying on internal controls to perform [] tests of controls" (KOB 27) does not explain how, in relying heavily on untested controls for the reliability of Koss IT system-generated information and leading substantive-only testing for all critical assertions that,

[27/] *See also, e.g.,* Exs. D-4 at 35 ("We did not test controls….That would be a fair statement [that the audit team had no basis for relying on the effectiveness of Koss's preventative controls], and I would say we did not rely on controls…[but] did a highly substantive audit"), 54 ("So here I obtained an understanding this is what [Koss] represented their [control] design was, and we did not test the operating effectiveness of these controls….We were not testing the operating effectiveness of controls."), 55 ("the steps that are tailored in there [on the audit program are] to obtain an understanding of those controls, not to test operating effectiveness of controls"), 60 ("As I've stated numerous times already, controls were not tested. We obtained an understanding of processes and controls. It was not required and we did not test controls.") & R-509 at 182 ("No….As I said earlier, relying on [Koss's automated accounting process] would have meant we needed to test controls. We performed a highly substantive audit to validate the balances and assertions.") (Audit Manager's investigative testimony).

in turn, relied heavily on that system-generated information, she bridged the gap in evidence between how Koss's accounting and IT systems were supposed to operate for each entire audit period at issue and how they actually did operate.[28]

Koeppel stated at the hearing that she did not "identif[y] control gaps or deficiencies" requiring her "to modify our nature, scope or timing of our work" (*see, e.g.*, AU § 311.03g (conditions "may require extension or modification of audit tests")), but

[28] The initial decision, in discussing in isolation the language "obtain evidence" and "perform other procedures" in AU §§ 319.65 and 329.16, repeatedly rejected any suggestion by the Division that the word "test" could be used in connection with those requirements, and indicated that the Division "offered no evidence" that "any auditor interpreted or applied [those standards] in that manner." I.D. 40-41, 50, 69 n.26, 73. To the extent Koeppel's briefing, perhaps to minimize those requirements, suggests at times (*e.g.*, KOB 24, KPHS 21) that the language of those standards could not under any circumstances call for audit testing, in terms of applying audit procedures to entity reports, and that no auditor in practice thought it did, that briefing is plainly mistaken.

As Koeppel has recognized (*e.g.*, KPHS 21, 26), an auditor may "obtain evidence" through audit testing. She has noted an instance in which PCAOB auditing standards refer to "procedures" as "substantive tests." KPHS 26, citing AU § 326.26. Tests surely can be "acts the auditor performs during the course of the audit to comply with the auditing standards," which is how AU § 150.01 describes "auditing procedures." In testimony, she referred on multiple occasions to "tests of reports," "testing of reports," "testing of these IT-generated reports," and "the need to test reports for completeness and accuracy." Tr. 1099-1108, 1187, 1340, 1351, 1442, 1498. As just and next discussed in the text, she links the level of substantive audit testing to the audit work on data reliability, and PCAOB standards provide that even where, unlike here, control risk is assessed at a low level, still the auditor should perform some substantive procedures for all relevant assertions related to all significant accounts (AU §§ 319.02, .107; *see* AU §§ 316.51, 312.32). Grant Thornton 2006 audit training materials on "Testing Client-Generated Data" stated, "Can use this information [in "system-generated reports"] without detail testing of underlying data…if we test the systems that generate the data." Ex. J-313 at 1, 10 (emphasis added, ellipsis in original), cited in DOB 9 n.42. Finally, we note that the *AICPA Audit Guide* in effect during the relevant period (and now) contained the following language (§ 204), evidently interpreting AU § 319.65: "[D]eveloping a preliminary audit strategy involves considering whether computer-produced records, such as accounts receivable aged trial balance, will be used as evidential matter to support an assertion. The auditor may test the computer-produced information by either of the following: [1] Testing the report substantively[;] [or] [2] Understanding the computer control activities that are intended to ensure the completeness and accuracy of such reports and performing tests of controls to assess the effective design and operating of such control activities" (emphases added).

the necessary audit work would have to have been done, absent control testing, to put her in a position to identify such matters, and the unmodified, "customary" audit work still needed to be adequate under PCAOB standards. A recurrent theme in the auditor testimony in this case, Koeppel's briefing, and the initial decision is that finding "no reason to believe" anything was amiss during the audits, based on an understanding of Koss's systems and controls, an assessment of inherent risk, Koss's IT system-generated reports, and Koss's paper binders of journal entries, necessarily supported the adequacy of the audit work. *See, e.g.*, Tr. 1334-35 ("We felt that based on the low financial statement risk, we had not identified any issues with reports generated by the IT system….Again, we did not identify anything that would cause us to dispute that we were receiving anything but all reasonable and appropriate information."), 1397 ("Again, we never saw any indication that reports generated by the system were not complete and accurate.") (Koeppel); KOB 24 ("the Division failed to point to any competent evidence that came to the engagement teams' attention that called into question the accuracy or completeness of the IT system-generated reports used in the Relevant Audits"), 29, 30; I.D. 43 ("the Division would have to show that" Koeppel "could not reasonably have relied on" Koss IT system-generated reports, rather than that insufficient audit work was done to determine their reliability one way or the other), 52 ("[t]he Division cited no circumstances that should have caused" Koeppel "to question the reliability of the trial balance reports," rather than evidence that she failed to obtain affirmative support for their reliability), 67 ("[the] Division offered no evidence that Koss ever reallocated customers among categories [in its sales reports], or that the engagement teams had any reason to believe that any such reallocation might have occurred," rather than that they did not affirmatively support the reports' reliability).[29/]

[29/] *See also, e.g.*, Tr. 82-83 ("the work that we did didn't contradict [Koss representations] at all") (2006-2008 Staff/In-Charge Auditor); Tr. 436 (no reason to think any of the information inputted into the accounts receivable confirmation testing sample was incorrect), 523 ("Based on our understanding of how the control structure worked, we…had no reason to believe that the system-generated reports were anything but accurate and the systems weren't producing accurate information"), 524-25 ("with our understanding of controls, and we had no…issues in prior years tying [the AR Aging Report] out, there was no red flag or anything to indicate that we needed to take it that additional step to tie it out at interim" and "it did tie out a year-end") (2007-2008 Staff/In-Charge Auditor); Tr. 714 ("I don't recall a reason to believe that I did not have the full listing [of last week of June sales].") (2007-2008 Staff Auditor); Ex. D-4 at 51 ("Based on the documentation and everything else that we saw in the files as it relates to auditing all of these other areas and looking at adjustments, we had no reason to believe it was anything other than what was being represented to us."), 85-86 ("Again, those [journal entries] were in the binders, and it was the upstream/downstream…we deemed them complete….Again, taking—going from the—their policy of the binders and then tracing them back in the other direction, finding [no] exceptions, we relied on the representations from management that they had provided everything….“[W]e found no exceptions in the journal entry testing that we did do. In looking at the analytics and the

In fact, the lack of contrary evidence asserted by Koeppel as a defense may well have been the very result of the audit work being inadequate. *See, e.g.*, AU §§ 326.25 (the auditor "should be thorough in his or her search for evidential matter and unbiased in its evaluation"), 316.08 ("Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively…. Management override of controls can occur in unpredictable ways."), .13 (the auditor "should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity"), .42 (as "there is a possibility that management override of controls could occur," "[e]ven if specific risks of material misstatement due to fraud are not identified by the auditor," the auditor should address that risk "apart from any conclusions regarding

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test of details that we did in every other area, finding no evidence of other adjustments to accounts through the review of the reconciliations or anything else, there was no reason for us to believe we needed to do anything further."), 87 ("Again, based on our assessment of the risks, we felt that the procedures we defined were sufficient to get us there, so, no, [that both sets of journal entry binders might be incomplete] was not a specific risk that was added or specifically tested for because there was no evidence that we were given anything other than what we relied upon."), 88 ("there was no indications that we weren't provided with everything" and "that was our conclusion, and we were ready to move on"), 127 ("So [sales revenue] was trending with our expectations. So there was no reason to test further.") & Ex. R-509 at 60-61 ("[Outstanding wire transfers did not] raise[] any additional red flags primarily because of our understanding of additional oversight and monitoring as well….There was no other evidence indicating in other areas that we need to dig further [concerning segregation of duties for cash]."), 110 ("The testing that we did was to look at the underlying journal entries and saw no exceptions and had no reason to believe anything further."), 127 ("in looking at the roll forward and reconciliations of numerous other accounts and the fact that there wasn't any other evidence that unusual adjustments in equity roll forwards or the roll forward for deferred accounts or any of the bad debt allowances, other accruals and looking at the activity that took place through those accounts, there is no evidence that we needed to do or follow-up anything further"), 132 ("Again, the testing that we had done across these areas, understanding the procedures, understanding that we saw these entries, nothing unusual coming through, we looked at the support, we saw the reconciliations and the activities going through every other area, and absent exceptions, our testing was complete."), 137 ("[as] we had no issues in reconciliations or anywhere else, we were done"), 144 ("Based on the sample [of journal entry forms] that we traced and lack of any evidence otherwise, that was the conclusion that we reached."), 147 ("Absent of exceptions, we deemed the binders to be complete and concluded our testing."), 179 ("We did completeness testing, pulling samples [from the journal entry binders], felt that we had everything and auditing those, we had no reason to believe that we had large reconciling items or other things that were showing up as anomalies.") (Audit Manager's investigative testimony).

the existence of more specifically identifiable risks"), .48 (in addition to other responses, auditor addresses risks of material misstatement due to fraud with "[a] response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur"), .57 ("[M]anagement is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways."), 319.51 ("in planning the audit, the auditor should be aware that when IT is used to automatically transfer information there may be little or no visible sign of [inappropriate] intervention [by individuals] in the information systems"), .80 (identified risks of material misstatement due to fraud that have continuing control implications, "whether or not transactions or adjustments that could be the result of fraud have been detected," may need to be communicated to senior management and audit committee), .94 (the auditor should consider that "the observed application of a control might not be performed in the same manner when the auditor is not present"), 329.10 ("When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.").

Regarding Koeppel's reliance on what she calls "an extensive risk assessment process" in the Koss audits (KOB 13), assessing risk properly is a required part of planning any audit under PCAOB standards. Although she invokes the process in argument, she does not explain why the basis of the risk assessments in these audits made any particularly special contribution to determining the completeness and accuracy of system-generated reports used in the substantive audit testing.

Moreover, the nature, timing, and extent of required substantive audit testing (and by extension, of audit work on the reliability of Koss IT system-generated data) are affected not only by the assessed inherent risk, which Koeppel highlights, but also by the assessed control risk (*e.g.*, AU §§ 312.01, .16, .24, .26-.32, 319.81, .106), which she dismisses without taking any serious account of it (*e.g.*, KOB 13, 30 n.20). Her arguments thus proceed as if inherent risk, including a list of factors in the work papers such as fraud risk and risk of errors in the accounting system, assessed as low, was the only relevant risk consideration in the audits.

In fact, each year control risk was assessed as high, resulting in what Audit Manager described in investigative testimony as a combination of risk "somewhere in between" low and high and what Grant Thornton described in audit guidance during the relevant period as "combined medium risk" (emphasis added). Indeed, Koeppel's refrain that she "set control risk at maximum" as a "default level" and not because she "determined that there was a high risk of material misstatements not being prevented or detected by internal controls" (*e.g.*, Tr. 1253; KOB 30 n.20; KPHS 12) ignores that, due to the auditors' admitted lack of control testing and their heavy reliance on mere understanding from company representations and on point-in-time observation, they were not in a position to identify or determine whether or how the controls actually operated over the audit period. This created a large gap in evidence.

Furthermore, even as to overall inherent risk, low risk did not mean no risk. Koss may, in Koeppel's view, have "sold a single type of product, managed all of its operations from its Milwaukee headquarters, and had a simple capital structure and organization." KOB 13 n.8. But even in assessing inherent risk as low, she identified certain risk factors as applicable that, as to the very least of them, meant that certain potential sources of mitigation were not present. *See* pp. 16-17 above, p. 124 below. And, as we discuss more in the journal entry section below, Koeppel recognized that fraudulent revenue recognition was a risk of material misstatement at the "very revenue focused" Koss. *E.g.*, Tr. 764-65, 1020-21, 1274-75, 1285-87; Ex. J-200 at 3, 4. As AU § 316.41 explains, "Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition." Koeppel also noted, "Due to the small size of the organization, there is a risk that the lack of segregation of duties may cause rise to fraudulent financial reporting." Exs. J-100 at 3, J-200 at 3; *accord* Ex. J-3 at 3; Tr. 830-32. In terms of opportunity to commit fraud (*see, e.g.*, AU § 316.07, .33), Koeppel knew from the 2004 IT review, as noted above, that Koss management stated that it relied heavily on its personnel at the departmental level (Ex. J-2 at 17) and from audit memos that "[m]any of the individuals in financial reporting have been performing their responsibilities for a number of years" (Ex. R-205 at 2 (2006), R-396 at 1 (2008)). She determined that susceptibility of Koss's inventory to misappropriation was a fraud risk. Exs. J-3 at 3, J-100 at 3, J-200 at 3; Tr. 1087. And she identified net sales, accounts receivable, and inventory as areas of relatively higher risk in each of the Koss audits, with a reasonable possibility of material misstatement. *See* pp. 10-12 above. The investors in a "small," "simple" issuer are no more to be deprived of the protection of an audit conducted in accordance with PCAOB standards than those of any other issuer.

Further on this point, in assessing fraud risks from Koss's IT system as low, Koeppel stresses that Koss's use of an outside contractor to manage its IT system limited "the potential for internal 'tinkering' with the system," in terms of system or program changes. But however that concern may have been addressed, it was still Koss personnel who actually entered data and used the system, and so the separate concern remained that "[t]he use of IT processing adds some additional IT risks as it relates to the susceptibility of altering information." *See* Ex. R-202 at 6; Ex. J-100 at 4;

Ex. J-200 at 2, 7; Tr. 1340-41 (in describing Koss audits, Koeppel testified that "one of the areas that we consider as it relates to both fraud risk and whether or not we need to modify our audit approach is the IT processing system and whether there is aggregate segregation of duties and responsibilities from those who are actually processing the transactions"); *see generally, e.g.,* AU § 319.36 ("management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made" not only to "computer programs" but "to data," or by "allowing unauthorized transactions to be processed").

Indeed, aspects of the fraud risk from use of IT, even if low overall, that are separate from unilateral internal changes to systems or programs can include: "[u]nauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions"; "[i]nappropriate manual intervention"; "access privileges" given to or gained by users "beyond those necessary to perform their assigned duties," possibly causing "a breakdown in segregation of duties" that "could result in unauthorized transactions or changes to programs or data that affect the financial statements"; "lack of control at a single user entry point" to a common database of information that affects financial reporting, which "might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data"; "[u]nauthorized changes to data in master files"; "[f]ailure to make necessary changes to systems or programs"; and "improperly authorized" changes to them. *E.g.*, AU §§ 319.19, .20, .30. The 2004 IT review and audit planning efforts in the 2006, 2007, and 2008 Koss audits recognized that these kinds of matters required attention from the auditors. *See, e.g.*, Ex. J-1 at 4-6; Ex. J-2 at 1, 14-16; Exs. J-3 at 4, J-100 at 4; Ex. R-202 at 2, 6; Ex. R-298 at 1, 3, 6; Ex. R-398 at 11, 18, 24. Also, when IT is used "to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more difficult to identify through physical inspection of printed documents." AU § 319.51. Koeppel recognized this circumstance needed to be confronted in the audits. *See, e.g.,* Tr. 1322-23, 1327-31; *see also, e.g.*, Exs. D-4 at 88 & R-509 at 124 (Audit Manager's investigative testimony).

Additionally on the subject of risk, Koeppel makes the argument that existence or occurrence of Koss's revenue and inventory were the relevant assertions for purposes of the Koss audits and that "any fraud at Koss was more likely to involve overstatement" rather than understatement of those income items or assets, seeming at times to claim that little or no effort had to be expended in the audits to determine the completeness of Koss IT system-generated reports used in the substantive testing of revenue or inventory. *E.g.*, KOB 45; KPHS 73; Tr. 898-99 (referring only to audit work on report's accuracy, not completeness), 932-35 ("Our concern is overstatements, so we want to make sure that the invoice that is showing up in the invoice summary register and rolling up through the AR distribution register is an appropriate invoice….As part of the test, that is a test of completeness, considering the risk that we're trying to address."), 1000 (tying detail report to trial balance only work on data reliability documented in work paper), 1099-1101 (claiming that tying entries listed in a report to source documents was a "completeness test"), 1107-08 (referring only to accuracy), 1187-88 (same), 1367-69 (same), 1399-1400 (same); *compare* Tr. 1349-50, 1359, 1498 (describing tying detail report to trial balance as completeness work) *with* Tr. 703-04 (2007-2008 Staff Auditor: conceding such tying is not a substitute for evidence of completeness and accuracy in many instances); *see, e.g.*, Tr. 453 (2007-2008 Staff/In-Charge Auditor: no audit procedures were applied to a particular Koss report to support its completeness), 473 (same). If Koeppel actually took this flawed position during the Koss audits, which she admits was not documented in the work papers (*e.g.*, KPHS 11 n.4), then that counts against, rather than supports, the adequacy of the data reliability work.

As noted, the PCAOB standard stating that the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition refers to both overstatement and understatement of revenue. AU § 316.41. Koeppel does not claim that there was no risk of understatement but instead that she "believed that any fraud at Koss was more likely to involve overstatement of revenues" and she was "focused more on detecting an overstatement of revenues rather than an understatement." KPHS 11 (emphases added); *see* Tr. 1286-87 (understatement of revenue "was not something we saw as a high risk for Koss") (emphasis added); *see also* Ex. R-507 at 75 (report of Koeppel expert: "the principal audit risk for revenues at Koss was overstatement"), 90 ("The auditor's primary concerns in testing the occurrence of sales are overstatements of sales that have the effect of overstating income.") (emphases added); Ex. R-508 at 45 (report of second Koeppel expert: "in companies such as Koss, where there exist incentives to maximize sales, accounts receivable, and assets generally, there is a greater risk of overstatement of these accounts than understatement") (emphasis added); Ex. R-509 at 71-72 (Audit Manager's investigative testimony: "In a retail manufacturing environment, the typical risk and critical areas are going to be revenue existence, did it really occur, is it really a sale, and is it recorded appropriately."). Moreover, as noted, susceptibility of inventory to misappropriation, which could result in understatement of inventory to conceal the misappropriation, was identified as a fraud risk in the Koss audits.

There is another problem with Koeppel's argument about her emphasis in the audits on overstatement, not understatement. According to Koeppel, that emphasis flowed from her assessment of risk with respect to the existence or occurrence assertion, and she implies that this risk assessment essentially rendered all but inoperative the requirement to obtain evidence about the completeness of Koss system-generated reports, in addition to evidence about accuracy. But Koeppel's argument seems to conflate that requirement of evidence of data completeness with the financial statement assertion of completeness. *E.g.*, Tr. 932-35 (in revenue area, for example, "the typical scenario is the overstatement of revenue"), 1156; *see* Ex. R-509 at 68-72 (Audit Manager's investigative testimony, making overstatement point by reference to "the completeness assertion" and remarking, that "[i]t's not typical to have completeness be a relevant assertion"). In fact, the requirement under AU §§ 319.65 and 329.16 to perform procedures and obtain evidence about completeness of system-generated information where controls are not tested is not confined to any particular assertion.

As yet another problem with Koeppel's argument, valuation of revenue, not just existence or occurrence, was a critical assertion in the Koss audits and was the subject of charges in the OIP. But she draws no distinction between her audit approach to data reliability in the testing of net sales and special sales allowances—involving deductions from sales that, if misstated, could lead to an overstatement of revenue—and in the testing of gross sales and receivables. *See, e.g.*, Tr. 1134-35.

Nor does Koeppel address the fact, which we discuss in detail in the accounts receivable section below, that the existence or occurrence assertion can be affected not only by items that add to the balance but also by items that subtract from the balance, and overstatement can be achieved by omitting subtractive items, not just adding false items. This makes completeness of reports used in substantive testing of existence and occurrence a matter of concern to the risk of overstatement as well as understatement. Indeed, as PCAOB auditing standards make clear, fraudulent financial reporting may be accomplished by "[m]isrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information." AU § 316.06 (emphasis added). Moreover, as the standards also point out, "Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization." AU § 316.09; *see* AU §§ 316.11, .31. Corporate fraud has involved recording fictitious, inappropriate, or unauthorized journal entries and "may involve extensive efforts to conceal how it is accomplished." AU § 316.08, .58, .62. The mere fact that the overall intent of a fraud may be to overstate an income item or asset does not mean that efforts to mask the fraud will not involve journal entries that understate such accounts. According to Koss's restatement disclosures, the fraudulent misappropriation of assets at Koss from 2005 through 2009 included overstatement of accounts receivable and cash. Ex. J-304 at 7, 48-50. Any notion that particular attention to the completeness of system-generated data can, in effect, be suspended wholesale in an issuer audit is misguided and insupportable.

Having considered Koeppel's two broad arguments about understanding of internal control and the risk assessment process in the Koss audits, and finding them to be unpersuasive, we now address her six other general arguments, which are all points about Koss's IT system. We come to the same conclusion as to these arguments that we did as to the two just discussed.

Koeppel, in further arguing that "substantial evidential matter was obtained about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP," relies on six claims concerning Koss's IT system and controls. KOB 24, 27-29; KPHS 22-24, 60-61; *see, e.g.*, Tr. 1342-47, 1349, 1397-99, 1485-90. Her briefs state those claims as follows: (1) the "comprehensive review of

Koss's IT systems performed in 2004 by GT IT specialists" "did not find any deficiencies that could impact the accuracy of the system's output"; (2) "an outside consultant managed Koss's IT system and was the only person authorized to implement changes to the system," providing "an additional level of control over the system by an individual who was not involved in the financial reporting process"; (3) "the AS/400 was a reputable, if aged, 'off-the-shelf' system" and "Koss had not extensively customized or altered the AS/400 standard financial programs," "so its functions were similar to what had been proven in the marketplace"; (4) "the system-generated reports were standard reports, used by Koss's own management in the ordinary course of business and produced through routine queries and commands"; (5) "Koss's accounting system was an integrated system, with transactions flowing automatically through various accounts and subledgers," which "minimized the opportunities for human error or intentional misrecording of transactions"; (6) "system access controls were in place, limiting changes to particular accounts to authorized users." KOB 28; KPHS 22-24, 60-61.

We have discussed the 2004 IT review in detail above. And the details matter. At one point, Koeppel's brief asserts that "it was appropriate to rely on the 2004 review as one piece of evidence supporting the completeness and accuracy of the system generated reports." KOB 27. According to her testimony, Koeppel carried forward the review in later audit years, relying on it as "a good foundation" and "foundational work," with "subsequent updating of that through discussions with the third-party provider," who managed Koss's IT system, "as well as management, about whether or not they made any changes to their system." Tr. 1342 (emphasis added), 1345. An audit team member elaborated that by 2008 the discussions "about updating just to get [the] general information on the systems in place, had they changed, any improvements they put in place," were primarily had with Junior Accountant. Tr. 222-23, 233 (2006-2008 Staff/In-Charge Auditor). We therefore examine the particulars and value of the 2004 IT review as a "piece of evidence" for what it may have contributed in relation to the purpose and extent of Koeppel's reliance on it. Neither she nor the initial decision, which she largely urges us to follow in this area, addresses that in any depth.

Contrary to Koeppel's contentions, addressing the full particulars of the review is not "tr[ying] to use isolated statements" instead of "view[ing] [it] as a whole" (KOB 22 n.8, 27 n.15). The details are considered here for what information they may have provided to an auditor required under the circumstances affirmatively to obtain support for the completeness and accuracy of system-generated information. Consideration of the details is not limited to whether they are "evidence that Koss's IT systems could not reliably provide accurate or complete information" (KOB 27 (emphasis added); *accord* I.D. 43), which is not what the Division needed to prove. It was enough to prove that the audit work did not provide adequate assurance of data reliability under the circumstances. Koeppel did not satisfy PCAOB auditing standards merely by noting that, as she vaguely and passively says, "no specific concerns about the reliability or integrity of the system surfaced through the work done by the audit teams to understand and document internal controls" (KPHS 60 (emphases added); *accord* I.D. 52, 67). And the details go to evaluating the weight of the review as a "piece of evidence" regardless of whether she did not categorize them as control deficiencies in the work papers documenting the understanding of internal control (KPHS 22 n.8). *See generally, e.g.*, AU § 319.102 ("Generally, when various types of evidential matter support the same conclusion about the design or operation of a control, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of a control, the assurance provided decreases.").

The limited scope of the procedures performed in and to update the 2004 IT review, and the review's age, meant those procedures shed little light on whether Koss IT system-generated information used in the 2006-2008 audits was actually reliable. As Koeppel acknowledges, the review was conducted "to understand the system" and did not purport to represent tests of controls existing in 2004 or in any later audit periods. Tr. 1342, 1473; KOB 27. As the IT review memo itself stated, "We reviewed the systems as communicated by the client," and the review was based almost entirely on "Inquiry of outsourced IT personnel," "Tour of the Milwaukee computer room," and "Review of selected client documentation." Ex. J-2 at 1. The "review" was not meant to be, and was significantly more limited than, a test of IT controls.

Moreover, no subsequent review of Koss's IT system was undertaken in the Koss audits, and instead in the 2006 and 2007 audits, general inquiries were made of the contractor about whether the IT system had changed, and in the 2008 audit these inquiries were directed primarily to Koss's accounting department itself, which Koeppel recognized provided less assurance than "a person outside of the company's financial reporting process." *See, e.g.,* pp. 39-41 above; Tr. 1375; KPHS 23, 61, 79. PCAOB standards provide that the auditor should consider that "the longer the time elapsed since tests of controls were performed to obtain evidential matter about control risk, the less assurance they may provide." AU § 319.97. Koss's IT controls were not even tested in 2004, and the review—which, despite its limitations, raised some significant issues of potential concern—provided only an understanding of Koss's IT system. This highlighted the importance of control risk in the 2006, 2007, and 2008 Koss audits.

Furthermore, the IT review memo did not include Koss system reports in its statement of purpose and made no reference to performing work on reports of any kind. No procedures were performed to test Koss IT system outputs or the integrity and reliability of any reports. None of the memo's conclusions discussed the reliability of system-generated reports. And there is no indication that system reporting was part of the review. The memo touched only on "the Company's overall control environment," its "use of leading IT management practices" (stating that Koss followed about two thirds of some 30 applicable leading practices but that its "[u]ser ID and password policies do not consistently follow leading practices"), and its "program change, database administration, and user access controls." *Id.* at 1, 7-10, 16.

The only testing specified in the memo was of “the IBM AS/400 user profiles for previous sign-on attempts, sign-on attempts not valid, and status.” *Id.* at 1, 13. This was documented in the IT review memo as “observ[ing] 48 user profiles from the IBM AS/400,” which, based on management’s response, did not capture all of the user profiles in the system and did not closely examine purported restrictions on the functions for which the users were cleared. *See id.* at 13-15. In any event, this testing resulted in a finding by the Grant Thornton IT specialists that “[t]he Company does not perform regular user access / segregation of duties reviews” and that “[a]s a result, some users may have excessive access to [its] financial systems,” and resulted in the specialists’ recommendations that “a policy be created to review and disable inactive AS/400 users, despite their status or title” and that “the IT department prepare quarterly user access lists that can be reviewed for inappropriate access rights by department managers / vice presidents. *Id.* at 15. The management responses provided in the IT review memo acknowledged that these matters did pose some risk but dismissed it as “low” (“[o]n a scale of 0 to 10, maybe a 2” as to user access and “a 1” as to segregation of duties and disabling user profiles). *Id.* This prompted a reply comment by the specialists that stressed the importance of the potential issues involved and pointed out, “Reviews of this Company’s IT controls by regulators, investors, or buyers would find control gaps that would be unacceptable based on IT control standards.” *Id.* at 16.

Overall, the IT review memo concluded (Ex. J-2 at 1, 14) that “[t]he Company has IT processes in place for managing program changes, managing access to production data around application controls, and managing user access to the Company’s CRT software system” for “Accounting (AP, AR, GL), Order Entry, Sales Reporting, Invoicing, Distribution, [and] Payroll” but that “[t]he controls related to those processes” were questionable. Those controls, the memo concluded, “appear to be primarily detective rather than preventative, although regular reviews of detective controls suggest that these controls are probably ineffective,” “[t]he IT vendors appear focused at functionality with little understanding or appreciation of IT control standards,” and “Company management appears to rely completely on the IT vendors” and to share their outlook.

Thus, the 2004 IT review did not discuss, test, or conclude on the completeness and accuracy of Koss’s IT system reporting. There is no indication that procedures in the review were specifically designed or intended to identify deficiencies in the IT system for the purpose of relying on system reports. Even with a limited scope of review, significant potential issues were raised, which will be further discussed in the rest of this section and in the journal entry section that follows. Inclusion in the IT review memo of only the three recommendations, one characterized as moderate risk and two as low risk, along with four further “observations,” was a product of the review’s limited scope, information, and procedures. The recommendations and observations must be viewed in that context, not as Koeppel sometimes suggests, as effectively a direct, fully informed seal of approval on the IT system’s output. KOB 27 n.17 (“‘GT’s review of Koss’s IT system found no significant deficiencies that would undermine the reliability of the standard IT reports used in the Relevant Audits’”) (quoting I.D. 42);

KPHS 60 ("The 2004 IT review did not identify any control deficiencies suggesting that reports generated by the system were unreliable or inaccurate."). A 2004 "review" that did not test Koss's IT system or its output, the passage of years since that review, and the updating of the review through general inquiries provided her with little more than an understanding of how the system was supposed to work, in contrast to evidence about how it actually worked, to support the reliability of system-generated reports.

Similarly overstated is Koeppel's second claim, that her knowledge about the outside contractor's role as manager of Koss's AS/400 computer system and "the only person authorized to implement changes to the system" contributes to a conclusion that "substantial evidential matter was obtained about the accuracy and completeness of the information produced by Koss's IT system." Although the contractor did not take part in the financial reporting process and was deemed "knowledgeable and helpful" by the 2004 IT review, the review found, again, the "IT vendors appear focused on functionality with little understanding or appreciation of IT control standards" and Koss "appears to rely completely on the IT vendors." Ex. J-2 at 1; Tr. 1342, 1375; *see* Ex. J-1 at 1 ("IT management (vendors) do not appear to fully understand IT controls standards.").

Moreover, knowledge that the contractor is the only one "authorized" to implement system changes does not mean that he is the only one able to do so. An understanding from the 2004 IT review (*id.* at 4, 11) that "[t]he entire AS/400 system is backed up quarterly," that "[e]very time a program is altered a log of who generated the change is automatically compiled and stored in the computer room indefinitely," and that the contractor "will view this log for errors" does not mean that all of this, in fact, happened as envisioned. Although the 2004 IT review memo noted that "[f]or the AS/400, the departmental / functional vice president requests the addition, deletion, or change for a user" and "[t]he vice president also identifies which programs are to be made available to [the] user," the memo did not provide specific details about those processes. *See id.* at 6. Indicating potential difficulties in governing and corroborating actual practice at Koss, the memo more generally referred to vice presidents being "authorized to initiate change requests (verbally or via email)," noted that "[e]mail requests are retained for a short period of time" only, and found that Koss did not have "a formal change control process, including the formalization of change requests, a procedure for retaining all requests, [or] documentation of user approval." *Id.* at 4, 14. The memo also concluded that the controls related to "IT processes in place for managing program changes, managing access to production data around application controls, and managing user access" to Koss's software system for accounting, order entry, sales reporting, invoicing, and distribution were "probably ineffective." *Id.* at 1, 2.

Even more importantly, as noted above, it was Koss personnel, not the outside contractor, who actually entered data and used Koss's IT system, and there were other risks from use of IT than unilateral internal changes to systems or programs. This included "IT risks as it relates to the susceptibility of altering information" and the processing of unauthorized transactions. *See, e.g.*, Ex. R-202 at 6 (2006 Koss audit work paper). The 2004 IT review indicated that Koss management placed a high degree of responsibility on its personnel at the departmental level. As management stated, “I think it is important to note our IT is in the hands of the users. Each area is responsible for it[s] data and the accuracy of that data.” Ex. J-2 at 17.

Koeppel’s related third and fourth claims, that the IBM AS/400 computers used by Koss were “reputable, if aged,” were “proven in the marketplace,” had “standard financial programs” that Koss had not “extensively customized or altered,” and produced, “through routine queries and commands,” “standard reports, used by Koss’s own management,” as well as by the auditors, also lack the weight and quality to support a conclusion that sufficient competent evidential matter about the reliability of Koss IT system-generated information was obtained in the Koss audits in question. Both Koeppel and the initial decision repeatedly use the term “standard report” without ever specifying what they mean by it or the basis for their use of that description here. As the Division notes (DOB 24 & n.99), the only support Koeppel cites for her claim that the Koss IT system-generated reports used for the audits were also used by Koss in the ordinary course of business is her bare assertion at the hearing, without supporting explanation about the reports in the testimony or audit work papers. When asked at the hearing if the auditors at any point went behind Koss’s IT system to look at what the reports were actually pulling from, Koeppel responded, in circular fashion, that “we didn’t think to do that, again, because they were system-generated reports.” She further asserted without elaboration that “[t]hey weren’t queries that were being done specifically for us,” “[t]hese were reports that management used,” and “[they] were consistently processed and prepared by the system.” Tr. 1488. Simply because a report has the same name or code number from one year to the next, which she stressed at the hearing (Tr. 1487-88), apparently to try to support these assertions, is not evidence that the contents of reports are complete and accurate. To bolster her last assertion, she also stressed the reports “tied out each time” to more Koss system-generated reports (Tr. 1350, 1485, 1488-89), which, as we discuss in detail later, was not adequate additional evidence of the reports’ reliability.

Furthermore, merely because Koss management may have considered the company’s IT system and the reports it generated to be good enough to manage the business, and in this sense “reputable” and “proven in the marketplace,” did not mean that Koeppel could assume they were adequate for audit purposes. For example, pertinent here are the findings of the 2004 IT review about Koss’s outside AS/400 contractor’s apparent focus on functionality and poor understanding and appreciation of IT control standards, Koss management’s apparently complete reliance on the contractor and sharing of its focus, prompting the Grant Thornton IT specialists to comment in the IT review memo, in response to management, “Auditing standards focus on IT Governance and controls rather than how ‘well oiled’ the process may seem.” Ex. J-1 at 1; Ex. J-2 at 1, 18; *see* Tr. 1483-86 (recognizing that Koss “preferred to put their dollars to [research] and development of products rather than internal systems”); *see generally* AU §§ 319.14, .40 (noting that “[a]n entity’s risk assessment,” the purpose of which is “to identify, analyze, and manage risks that affect entity objectives,” “differs from the auditor’s consideration of audit risk in a financial statement audit,” the purpose of which is “to evaluate the likelihood that material misstatements could occur in the financial statements”). At the hearing, Koeppel pointed out that the “marketplace” of users of IT systems like Koss’s included most of her private company audit clients (Tr. 1483-85), which do not have the responsibilities of a public company like Koss and whose audits need not comply with PCAOB standards. Additionally, if an IT system error or a fraud is occurring at a company, then its system-generated reports naturally could be affected, and those reports could be used in the business by company personnel who were not aware of that fact, or the false appearance of such use could be created. Mere use of the reports by management or employees need not signal that the reports are reliable for use in substantive testing in an issuer audit.

As to Koeppel’s claim that the “standard financial programs” running on Koss’s computers had not been “extensively” customized or altered, she again displayed the lack of a clear understanding when she asserted at the hearing, again without elaboration in the testimony or discussion in the audit work papers, that there was “very little tailoring” and that “most of” the inquiries “were standard, or if they had been customized, they have been customized years before, and they were using the same inquiries to generate reports repeatedly.” Tr. 1485-86. Her testimony thus indicates that there was some customization or altering of the computer or financial programs to Koss’s business, which stands to reason, and potentially created an individualized opportunity, specific to Koss’s circumstances, for error in the capture, summarization, or presentation of data or for fraud. She specifically points out that viewing Koss’s general ledger, maintained only in electronic form, would be “mediated” by “the software and commands that were used to make particular journal entries appear on the computer monitor.” KPHS 70. The printed output of Koss’s IT system was likewise mediated by components of the system, yet, contrary to the claims Koeppel now makes in briefing (KOB 28; KPHS 24), they were not “thorough[ly]” understood in the audits.

Koeppel’s fifth and sixth claims, about Koss’s “integrated” accounting system and “system access controls [] in place” are likewise unavailing. To be sure, PCAOB auditing standards recognize that the audit client’s use of IT can provide benefits that may mitigate the risk of misstatement. *See, e.g.,* AU §§ 319.18, .30, .43-.44 (discussing controls that “apply to the processing of individual applications” and “may be performed by IT”), .46 (“when IT is used in an information system, segregation of duties often is achieved by implementing security controls”), .51 (automated processes and controls “may reduce the risk of inadvertent error”), .78 (“Because of the inherent consistency of IT processing, the auditor may be able to reduce the extent of testing of an automated control.”), .85 (“because of the inherent consistency of IT processing, performing procedures to determine whether an automated control has been placed in operation may serve as a test of that control’s operating effectiveness, depending on such factors as whether the program has been changed or whether there is a significant risk of unauthorized change or other improper intervention”). But “IT also poses specific risks to an entity's internal control." AU § 319.19. These include fraud risks discussed above. Indeed, automation does "not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system," and "when IT is used to automatically transfer information there may be little or no visible evidence of such intervention in the information systems." AU § 319.51. Also, "errors may occur in designing, maintaining, or monitoring automated controls." AU § 319.21. Other risks from use of IT include, for example, "[r]eliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both," "[f]ailure to make necessary changes to systems or programs," and "[p]otential loss of data." AU § 319.19. Correct information needs to be entered into the system and incorrect information needs to be caught. The auditor obtains evidence about the actual operation of controls over the audit period, not merely, as here, gains an understanding of how they are supposed to operate, including making fragmentary, incomplete observations of their operation at one point in time and accepting representations without any exploration. For these reasons, the information about Koss's "integrated system" and "system access controls" only scratched the surface of the issue of "opportunities for human error or intentional misrecording of transactions" (KOB 28).

This is exemplified by Koeppel's contention at the hearing that both system integration and access controls would prevent what the hearing officer referred to in questioning as a "garbage in, garbage-out problem." Tr. 1489-90. Koeppel argued that "if you had bad information in there, the system is going to fall apart…the reports are not going to be consistent." *Id.* In so arguing, she ignores the issue of management override of controls and manipulation of the system through false entries that could produce incorrect reports that nevertheless were consistent with one another or could make accounts balance. More generally, as the Division notes, "Koss's integrated accounting system" could create problems of its own for data reliability (DOB 23); incorrect information, like correct information, could be "simultaneously posted to relevant accounts" and "flow[] automatically through various accounts and subledgers" (KPHS 23, 61), and the risk existed that "the subledger accounts would not agree with the general ledger accounts, due to timing or to direct manual entries" (DOB 23). Koeppel further argued that, due to the "overall access controls to the system," "somebody else couldn't get into that system to put in garbage." Tr. 1489. Indeed, user identifications and passwords were emphasized in the documentation of the walkthroughs in the audits. *See, e.g.,* Exs. J-49 at 1, 4, R-300 at 16, 19, 22, 26-28, 30, 31, R-398 at 16, 21, 23, 25. But, again, that does not address the risk of fraud or error by persons authorized to use the system. Nor does it address the issue of system error in the computer system and financial programs, as applied to Koss's business.[30/]

[30/] In testimony, Koeppel claimed that using various Koss system-generated reports and tying them to one another "validat[ed] that information is accurate and consistent" because "we're getting the same information" "sliced and diced in different ways." Tr. 1336-37, 1349-50, 1371, 1488-89. But if those reports, which Koss staff printed out at a

Similarly, as to access controls, the narrow scope of the 2004 IT review and the potential concerns raised by the firm's IT specialists are discussed above. Koeppel argues that "[e]vidence about such access controls was obtained through journal entry control testing and through direct observation of user's access during walkthroughs." KOB 28. We address the inadequacies of the purported journal entry control testing, and related walkthrough observations, in detail in the journal entry section below.

We therefore reject eight of Koeppel's nine arguments that the evidence obtained in the 2006, 2007, and 2008 Koss audits was, as the initial decision put it, sufficient to support the completeness and accuracy of reports generated by Koss's IT system "as a general matter," or, as Koeppel puts it, constituted "substantial evidential matter…about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP." Discussion of Koeppel's ninth argument follows in the sections analyzing the audit work in the individual audit areas.

2. Journal entries

There is no dispute in this case that a fundamental prerequisite to performing journal entry testing, as required by applicable PCAOB auditing standards, is to obtain a complete population of journal entries for the year under audit. *E.g.,* Tr. 764-65, 776, 792-94, 801-05, 808 (Koeppel). Among Koeppel's "years of training" in journal entry testing, Grant Thornton's August 2006 and January 2007 training made clear that auditors "must address completeness" of the population used to select journal entries for fraud testing; that "We need to make sure the population is the **entire** population"; that "If you do a good job testing journal entries but you never had the full list of journal entries, what have you accomplished? Don't waste your time on an incomplete file!"; and that when management creates a listing of journal entries or provides paper copies of journal entries maintained in a binder for the auditor, "if there was fraud, management probably would not include the fraudulent entries" on the list and "[c]opies of fraudulent journal entries would likely not be in the binder." Ex. J-130 at 4, 20-22 (bold in original); Tr. 1330. Koeppel testified these statements reflected her views during the audits in question. Tr. 802-08. She said she made it a point in the audits to "make sure we had a complete set of journal entries" (Tr. 1329) or, as Audit Manager put it, to "make sure we were looking at everything for the journal entries" (Ex. R-509 at 111). As Audit Manager noted, "you can only evaluate what you're seeing, and if it's not there, you can't appropriately evaluate" and "[w]hen evaluating[,] whether or not you're looking for

particular point in time and could not be reproduced after that date, were all individually subject to manipulation by Koss management or staff or were all drawing from the same block of data that was incorrectly entered or processed by staff or Koss's IT system, or that was being manipulated by management or staff in the various reports—matters with respect to which we find insufficient audit work was done—there is no "validating."

things that are unusual in nature and nonstandard, you can't evaluate what's not there." *Id.* at 94 & Ex. D-4 at 82-83 (investigative testimony). Koeppel does not contest that in the respects pertinent to the journal entry charges, she herself was aware of the audit procedures performed and evidence obtained. *See, e.g.*, KPHS 28, 30, 32, 65-71. We have discussed the facts of the journal entry work in detail above. *See* pp. 33-49.

In summary, completeness was specifically called to Koeppel's attention as a concern during the 2006 Koss audit, when the PCAOB inspection of the 2005 Koss audit included a negative comment in that respect on the 2005 journal entry testing. Again, the importance of having a complete journal entry population and the danger of relying on management-provided lists or binders, from which fraudulent entries could be excluded, was also impressed upon Koeppel in firm-wide audit training in August 2006 and January 2007. In planning each audit, she recognized that revenue recognition and management override of controls were fraud risks at Koss and identified the small size of the organization, including its three-person accounting department, as giving rise to a risk of fraud from lack of segregation of duties. In particular, she recognized that consideration of any controls (or lack thereof) Koss had in place to address identified fraud risk factors "would need to include an added sensitivity to management's ability to override such controls" and that it was necessary to "closely review unusual journal entries and perform journal entry control testing." Koeppel knew that, due to asserted limitations of Koss's IT system, the auditors did not have an electronic download or computer-generated list of all of Koss's journal entries, which she regarded as "definitely the preferred method to get the information." Tr. 1330. Nor was it feasible in the audits to use what Koeppel described as "a nice way to get comfort" by "identify[ing] numbers that were missing" because Koss's journal entries were not "numbered sequentially." Tr. 1322-23. It was therefore necessary to "audit around" the limitations by some other means. *See* Ex. R-509 at 93, 124 (Audit Manager's investigative testimony).

Yet, after consulting with another Grant Thornton partner in the latter half of 2006 and making the judgment that the general concept of "upstream/downstream testing" was "an effective way" to "make sure we had a complete set of journal entries," Koeppel did not provide any input into, and did not ascertain why Audit Manager decided to use, the particular approach to such testing she did in the 2006, 2007, and 2008 Koss audits. *E.g.*, Tr. 835-37, 1329, 1492. Koeppel also decided not to discuss that approach with anyone else because, according to her testimony, she "did not see a need to elevate that to somebody outside of the engagement team." Tr. 1322-3, 1329, 1452-55, 1492.

Instead, she simply approved, as the critical completeness test, that tracing back and forth of a sample of journal entries from one set of paper binders to another set, both openly accessible and prepared in a manner untested in the audits by a member of Koss's three-person accounting department. And she was ultimately content to accept, or infer from, their representations that each binder contained a complete set of the year's journal entries, in forming her audit conclusions and authorizing issuance of the audit opinions. *See, e.g.,* Tr. 1334-35 ("we did not identify anything that would cause us to dispute that we were receiving anything but all reasonable and appropriate information"); *see also* Tr. 92-96; Ex. D-4 at 85-86 (Audit Manager's investigative testimony). Koeppel concedes that the tracing would not identify items omitted from both sets of binders and that applying audit procedures to an incomplete set of journal entries would be a "waste [of] time." Tr. 795, 802-08, 837-38, 1151-53, 1493; *see* Tr. 107-110 (2006-2008 Staff/In-Charge Auditor); Tr. 705-06 (2007-2008 Staff Auditor).

The Division argues that Koeppel therefore violated AU §§ 110 and 316.61 and also failed under AU § 230 to exercise due professional care, including professional skepticism, with respect to the journal entry testing. *E.g.*, DOB 7-10. Koeppel counters with four main arguments. First, as in the other audit areas, she argues that the journal entry charges must be dismissed because she did not personally perform the detailed audit testing and the case could only be charged as a failure of supervision or planning. *E.g.*, KOB 20, 41, 42; KRB 4. Second, she contends that, in each audit, other work on journal entries and perhaps other work in the audit more generally compensated for any limitations of the upstream/downstream testing. *E.g.*, KOB 42-43; ArgTr. 63-64, 66, 67-68. Third, she seems to claim that she had or was provided with no alternative to the approach she took to the journal entry testing. KOB 23 n.14, 40. Fourth, she argues that the initial decision only found that the journal entry work did not fully comply with PCAOB auditing standards because the decision "inappropriately shifted the burden of proof" from the Division to her. KOB 40, KRB 5-6, 9. We agree with the Division. Our discussion of engagement partner responsibility in Section V(A) disposes of Koeppel's first argument, and we discuss and reject her other arguments below.

For Koeppel's second argument, she points to other procedures and information in each audit than the tracing a sample of journal entries from one paper binder to another. She contends that, "[i]n the context of the assessment of the fraud risk at Koss as 'low,'" these other items gave an "understanding" of "the overall control environment" or "well-controlled environment" of "segregation of duties," "monitoring controls," and "access controls" that "existed over journal entries" and served as "multiple additional sources of assurance" that "bear[] on the completeness of the population of journal entries being tested." KOB 42; KRB 7-8; Tr. 1142, 1300, 1328-29, 1493-94. Namely, she cites: (1) asserted "journal entry control testing"; (2) Koss's "use of consistent numbers for standard entries" and audit "review of the numbering" of entries; (3) Koss's printing of the so-called update reports "on multiple pages of greenbar paper that still had their perforated pages attached to each other"; (4) "information provided by Koss's third-party IT contractor and Koss's accounting staff" that its IT system generated an update report each time a journal entry was posted to the general ledger; and (5) responses by Koss's accounting staff to inquiries about "whether any improper journal entries had been made" and related management representations. KOB 42-43; KRB 6-9; KPHS 29-30, 67-68; Tr. 824-29, 857, 1143-44, 1300, 1451. But whatever "additional assurance" this spotty or surface-level work and information provided left the fundamental completeness problem intact.

As an initial matter, Koeppel frames her discussion of these five items by placing them in the context of the assessed fraud risk in the 2006, 2007, and 2008 Koss audits. Specifically, risk assessment work papers in each audit identified only one of the 12 listed fraud indicators under "Inherent Risk Indicators-General" as "Applicable" ("Pressure to meet expectations of analysts, creditors, and others") (Exs. J-70 at 3, J-178 at 3, J-278 at 3); identified all three "Fraud and Other" indicators listed under "Inherent Risk Indicators-Assertions" for revenue existence/occurrence and valuation as "Not (Rarely) Applicable," including "Potential for fraudulent financial reporting" and "Potential for misappropriation of assets" (Exs. J-71 at 1, J-179 at 1, J-279 at 1); and assessed as "Low" the "Financial Statement Risks" of "Fraudulent financial reporting" and "Misappropriation of assets" (Exs. J-72 at 1, J-180 at 1, J-275 at 1).

Yet, as noted above, this was in a larger context in which it was understood that overall inherent risk was assessed as low but control risk was assessed as high, calling for a combined medium risk strategy in the audits. And as also discussed above, even as to inherent risk, low risk did not mean no risk.

Moreover, "[e]xamining journal entries and other adjustments for evidence of possible material misstatement due to fraud" is a procedure that PCAOB auditing standards require "in addition" to "overall responses" to the risk of material misstatement due to fraud and "responses that address specifically identified risks" of such misstatement; it is a procedure that "should be performed to further address the risk of management override of controls," "given the unpredictable ways in which such override could occur" and given that material misstatements "often involve" the manipulation of the financial reporting process by "recording inappropriate or unauthorized journal entries" or other adjustments. AU §§ 316.02, .08 & n.6 ("[f]rauds have been committed by management override of existing controls using techniques such as…recording fictitious journal entries"), .48, .57, .58, .61; *see* AU § 316.42 (auditor "should address that risk"—override of controls—"apart from any conclusions regarding the existence of more specifically identifiable risks"). Still further, AU § 316's repeated references to "the general ledger" in describing the required journal entry testing (AU §§ 316.58, .61)—which reflect that a complete population of entries is a fundamental premise of the testing—are not tied to any particular level of assessed fraud risk. Nor are they dependent on any particular level of assessed control risk. Even where it is established through proper audit testing, not the so-called journal entry control testing in the Koss audits, that controls over journal entries are implemented and operating effectively, completeness is no less a prerequisite to the identification and testing of specific journal entries, which is still required under AU § 316.61. Work papers reviewed by Koeppel acknowledged the need for "an added sensitivity to management's ability to override" any controls "the entity has in place to address the identified fraud risk factors" and, in light of the risk of management override of controls and the risk of lack of segregation of duties, to "closely review unusual journal entries and perform journal entry control testing." *See* Exs. J-3 at 3, J-100 at 3, J-200 at 3, 4.[31]

Although Koeppel suggests that what she calls journal entry controls testing mitigated the risk of material misstatement due to fraud and lessened the audit effort necessary in the journal entry area, PCAOB auditing standards make clear that "[e]ffective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of those controls" and that "even though controls might be implemented and operating effectively, the auditor's procedures for testing journal entries and other adjustments should include the identification and testing of specific items." AU § 316.61 (emphasis added). Koeppel herself believed that "tests" and "testing" were key in the Koss audits "to validate or negate" the potential lack of segregation of duties (which she deemed relevant to the completeness of the journal entry binders) and to "validate," more so in 2007 and 2008 even than in 2006, "our understanding of the process" and "our understanding that there had been no changes in the process." Tr. 1144-47, 1199, 1300-03, 1306. As we discuss below, the journal entry control-related work did not test the operating effectiveness of those controls and, at best, provided little "additional assurance" of the completeness of the population of journal entries selected for audit testing, on which the value of that testing depended.

Koeppel also tries to frame the discussion of the five items by arguing broadly that to expect any more than the journal entry testing she accepted as adequate would adopt an "interpretation of AU 316.61" that is "novel" and "fundamentally incompatible" with PCAOB standards and that "would place an impossible burden on auditors" by requiring them to "anticipate *every* potential fraudulent scheme," "*all* fraudulent

[31] At the hearing and in briefing, Koeppel has seemed to try to downplay the reference to lack of segregation of duties by describing it merely as an identification of "a potential fraud risk" arising from Koss's "small accounting department" and "a consideration in our planning," "done on a preliminary basis," prior to the performance of audit tests "to validate or negate that potential lack of segregation," and by isolating "efficiency" as a factor in not testing Koss's internal controls. Tr. 779-84, 832, 1254-55, 1302-03, 1495; KOB 30 n.20, 42; KPHS 18; *see* Ex. R-509 at 40-41 (Audit Manager's investigative testimony). But that risk was significant enough to be "primarily" the reason "GT did not conclude that" "a number of controls in place to mitigate the risk of loss and/or fraud" at Koss "brought control risk to a LOW level" and, "[a]s such, GT has not placed reliance on those controls," and to call for "close[] review of unusual journal entries" and "journal entry control testing." *See* Exs. J-3 at 3, 4, J-100 at 3, 4; *see also* Ex. J-200 at 3, 4; Tr. 810. Koeppel testified that it was "very important" to her that a "senior official should not have access to both create, post and approve journal entries" and that she "would want to take careful note of" circumstances that "could've resulted in a lack of segregation of duties." Tr. 1302-03, 1307-08. And, as performed, the stated audit responses to the risk left a hole in the audit evidence, as we discuss below.

schemes," and "every potential fraud," "no matter how improbable and no matter how difficult it would be to perpetrate," or to "detect" the precise fraud that may have taken place. KOB 1, 41, KRB 4, 9. This hyperbole ignores the real issue here, which is that the auditor needs to respond to a clear gap in evidence on a critical point. As in *Wendy McNeeley, CPA*, "[t]he gravamen of the charge against" Koeppel "is not her failure to uncover the fraud itself, but her failure to adhere to [applicable auditing standards] during the audit." SEC Rel. No. 34-68431, 2012 WL 6457291, *12 (Dec. 13, 2012).

Koeppel has acknowledged that selection of journal entries from a complete population is necessary to proper journal entry testing under PCAOB standards, she was unable to identify any work in the audits in question that would have provided evidence that any items were missing from both sets of journal entry binders, and she has offered no argument why items could not be removed from two sets of binders at Koss as easily as from one. *See, e.g.,* Tr. 776, 827, 1149, 1493. Reminding auditors that "[w]e must address completeness" and that "[t]his must be done," Grant Thornton training that Koeppel attended during the relevant period specifically observed from experience that "common excuses" why an audit team "believes they tested completeness or why they could not test completeness," such as obtaining a client-prepared "list of journal entries" or "'paper copies of journal entries maintained by the [client] in a binder,'" are "no excuses" because, quite commonsensically, the list "would probably not include [any] fraudulent entries" and "[c]opies of fraudulent journal entries would likely not be in the binder." Ex. J-130 at 20-22. The auditor needs to test journal entries, and that requires effectively addressing what is an essential premise of doing the testing in the first place—that the population subject to testing is complete. This is not a matter to be left to hypothesis or prediction about a particular method of fraud.

Completeness, and the audit work necessary to confirm it, is so important precisely because, as PCAOB standards take pains to caution auditors:

- "management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively," which "[f]raudulent financial reporting often involves";

- "[b]y its nature, management override of controls can occur in unpredictable ways";

- "[t]ypically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization," as "by withholding evidence or misrepresenting information in response to inquiries or by falsifying information";

- "material misstatements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished";

- "the auditor cannot assume that the inability to observe" some of the conditions often present in circumstances where fraud exists "means there is no risk of material misstatement due to fraud," and the extent to which each condition is "present when fraud occurs may vary"; and

- "inappropriate journal entries and adjustments might be made to other accounts" than those "associated with an identified risk of material misstatement due to fraud."

AU §§ 316.08, .09, .27, .31 ("fraud is usually concealed"), .35, .36, .48, .57, .61, .62; *see* AU § 316.04 ("the opportunities to commit fraud can be reduced significantly," but by implication still be present, even when "management and those responsible for the oversight of the financial reporting process fulfill th[eir] responsibilities").

Likewise, PCAOB auditing standards are replete with warnings that fraud can occur through collusion:

- "[m]anagement can either direct employees to perpetrate fraud or solicit their help in carrying it out";

- "controls, whether manual or automated, can be circumvented by the collusion of two or more people"; and

- "[f]raud [] may be concealed through collusion among management, employees, or third parties," in that, for example, "through collusion, false evidence that controls have been operating effectively may be presented to the auditor, or consistent misleading explanations may be given to the auditor by more than one individual within the entity."

E.g., AU §§ .08, .10, .43, 319.22; *see* AU § 316.06 ("[f]raudulent financial reporting need not be"—but by implication can be—"the result of a grand plan or conspiracy"). Koeppel's argument unconvincingly proceeds as if none of this had any implications for the importance of completeness and of audit work rigorous enough to confirm it.[32/]

[32/] Koeppel's briefing seems to assume that a "collusive fraud" (KOB 41) at Koss was unfathomable, that the possibility did not even need to be considered, much less addressed in any way in the audits, for she does not point to anything that did so, and that a material misstatement due to fraud could only have occurred at Koss through collusion if there was "a total breakdown in their control structure" (Tr. 1493). But she chose not to test internal control over critical assertions, and an understanding of how

In light of these challenges, fulfilling the responsibility under the standards "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement" (AU § 110.02) and Koeppel's stated approach of "close[] review [of] unusual journal entries and perform[ance of] journal entry control testing" and "an added sensitivity to management's ability to override such controls" (*e.g.*, Tr. 779-81, 810, 824, 830-31; Tr. 536; Exs. J-3 at 1, 3, J-100 at 3, 6, J-200 at 3, 7; Tr. 779) were stymied at the outset by such heavy reliance as she placed on paper binders from which journal entries admittedly could have been excluded.[33/]

The first category of items cited by Koeppel as a source of assurance about completeness other than the upstream/downstream procedure is so-called journal entry control testing. As outlined by her, this "include[d] work that was performed to obtain an understanding of Koss's systems and processes" and essentially consisted of: inquiry about "the monitoring controls that existed as it related to journal entries" (meaning VP-Finance and "the active role played by Koss's CEO/CFO in reviewing [its] financial position and processes, including journal entries"); "review of access" (considering a user profile list from Koss's IT contractor) in 2006 and "our understanding that there had been no changes in the process" in 2007 and 2008; "direct observation of system access controls" and taking a "look at journal entries" in so-called walkthroughs of an individual transaction; and "testing segregation of duties" by examining handwritten

Koss's controls were supposed to work, along with limited audit work she describes as "testing" journal entry controls, did not do enough to determine whether the journal entry population subject to fraud testing was, in fact, complete, as we discuss below. Moreover, Koeppel identified the "small size of the organization," including Koss's three-person accounting department, and the fact that "[t]he operating and financial decisions are dominated by a few individuals [at] Koss" as potential fraud concerns. *E.g.*, Exs. J-3 at 3, J-70 at 2, J-178 at 2, J-278 at 2; Exs. J-100 at 3, J-200 at 2, 3, 4; Tr. 778-81, 810-13, 829-32; *accord* Ex. R-509 at 62-63 (Audit Manager's investigative testimony).

[33/] Koeppel notes that the issue about the completeness of Koss's journal entry population subject to fraud testing that was cited in the 2005 PCAOB inspection comment form was not cited in the 2005 PCAOB inspection report as resulting in an insufficiently supported audit opinion. KOB 11; Tr. 1317-18. She then suggests that she could assume from this fact that there could be no "fail[ure] to obtain sufficient competent evidential matter" as a result of a completeness problem with the journal entry testing in the 2006, 2007, and 2008 Koss audits. KOB 11. But the way in which the completeness issue was cited in the 2005 inspection report, based on the aspects and circumstances of the 2005 Koss audit that were considered and the work that was done in that inspection, does not represent a conclusion that nothing more needed to be done on completeness to support the opinions in the 2006, 2007, and 2008 Koss audits. Any finding of violation we make here regarding the three audits in question is based on the full record developed in this exhaustively litigated disciplinary proceeding.

journal entry forms compiled in binders by a member of Koss's accounting department. *E.g.*, KRB 8; KPHS 29; Tr. 825, 1142, 1147, 1300, 1306, 1311, 1451, 1493-94.

PCAOB auditing standards make clear that "because management may have the ability to override controls that otherwise appear to be operating effectively," "it is unlikely that audit risk can be reduced to an appropriately low level" through "only tests of controls"—much less merely an understanding of controls—and that, "even though controls might be implemented and operating effectively, the auditor's procedures for testing journal entries and other adjustments should include the identification and testing of specific items." AU §§ 316.51, .61. As discussed, the particular upstream/downstream testing left a clear gap in the evidence of completeness of the journal entry population, and the particular control-related procedures did not come close to filling that gap. Instead, the latter comprised a flawed effort purportedly showing there was no reason to believe false journal entries could be recorded in the first place. It was based on the same paper binders of journal entry forms used in the upstream/downstream testing; more representations from the same small accounting department viewed as possibly lacking a segregation of duties; imprecise, inconsistent, and potentially troubling understandings about company processes; an untested, one-time 2006 list of Koss IT system user profiles, not regularly reviewed by Koss and updated by the auditors through general inquiries; one-off observations; and conjecture.

To begin with, the "understanding of Koss's systems and processes" (KRB 8) that underlay the purported journal entry control testing was itself problematic. Koeppel understood that Senior Accountant and Junior Accountant posted journal entries to accounts for which the former prepared reconciliations. Koeppel also accepted VP-Finance's claim that she herself reviewed, but could not post, journal entries and that VP-Finance reviewed account reconciliations while additionally performing the bank statement reconciliations for at least 2006, having access to and authority over Koss checks, and being responsible for writing off accounts receivable. *See, e.g.,* pp. 39, 92 above. This understanding raised potential concerns of its own about segregation of duties. *See, e.g.*, Tr. 1145-47 (Koeppel); Ex. D-4 at 68-72 (Audit Manager's investigative testimony: "[i]t appears that way, yes," that VP-Finance had custody, authorization, and record keeping abilities, a concern supposedly addressed by President/CEO's review of bank reconciliations, though "I don't recall any specific evidence" of such review, only what "I took [] to mean" from what VP-Finance said); Ex. J-7 (2006 audit program: "GT notes that these individuals do prepare reconciliations of the accounts that they post entries to," a concern supposedly addressed by VP-Finance's claim that she herself "reviews all account reconciliations and the journal entries must be authorized by [her] as well"), Ex. J-9 (Koeppel's sign-off on notation).

Moreover, VP-Finance's claim about not being able to post journal entries was inconsistent with the statement in the work papers for all three audits, which each year was reviewed by Koss management, that VP-Finance and Senior Accountant "have access to create standard and non-standard journal entries." *See* pp. 34-36 above;

Exs. J-4 at 2, 3 (signed off on by Koeppel in 2006), J-101 at 2, J-201 at 2, 3 (same in 2008). Even if VP-Finance did not have direct access to post entries, she could have influenced them. This was inherent in her review role, which presumably included the ability to reject an entry and give instructions for modifying it. And nothing prevented her from being involved in the process of creating the proposed entries in the first place. In fact, a 2006 work paper stated, "GT notes that all journal entries are created on paper by…VP of Finance, and entered into the system by…Junior Accountant. [President/CEO] reviews [VP-Finance's] journal entries through review of the monthly financial statements." Ex. J-11 at 4. Audit Manager explained in the investigation that "[b]ased on certain calculations in certain areas, it was possible that [members of Koss's accounting department] were outlining what the calculations and what the entry was that should be recorded" and VP-Finance "may work on the origination and tell individuals what the entries needed to be…she had some involvement," though "the sample that we tested" did not include any journal entries drafted by her. Ex. R-509 at 139, 142-44.

Although Koeppel's expert witness conjectured that "the working papers show that [Senior Accountant] and [Junior Accountant] were appropriately experienced and familiar with Koss's operations," such that "[VP-Finance] or others at Koss would be likely unable to deceive either accountant into posting inappropriate journal entries without their awareness" (Ex. R-507 at 54-55), the expert cited a 2008 work paper stating that Senior Accountant and Junior Accountant had been employed in their current roles "for several years" (Ex. J-204). Koeppel understood at all times during the audits that both of these individuals reported to VP-Finance, who, unlike them, was a certified public accountant, had worked at Koss for a considerably longer time, was identified by Koss as among its "Officers and Senior Management," and was one of two Koss officers who signed Koss's Form 10-Ks. *See, e.g.*, Tr. 1478, 1502; Ex. J-59 at 40, 41; Exs. R-205 at 2, 5, R-396 at 1, 5. The expert addressed none of this evidence.

Nor do Koeppel or the expert take account of some key facts as to VP-Finance's claim to review all journal entries, a claim on which Koeppel heavily relied. VP-Finance worked part-time and was not at the office every day. Tr. 1495. There is no claim or evidence that an electronic approval was required to post an entry or of any bar to it being "initiated and recorded online with no physical evidence" (AU § 316.59) left behind. *See, e.g.,* Ex. R-509 at 117-18, 142. As far as the auditors knew, to the extent VP-Finance looked back at past journal entries, she used the binders, which the record indicates she did not necessarily compile and over which the auditors did not identify or test any controls. *See, e.g.*, Tr. 46, 51, 54, 334-35, 555, 827, 1473; Ex. D-4 at 45.[34/]

[34/] Koeppel's expert simply described, in hindsight, the precise fraud reported to have occurred at Koss from at least 2005 through 2009, as though it exhausts the possibilities, and assumed that collusion was "required" (Ex. R-507 at 55), as did her counsel's question to Koeppel about her belief that VP-Finance admitted in a plea agreement that "the" fraud began in 1997 (Tr. 1215). But the record, as noted, as well as documents of which we can take official notice for the limited purpose of responding

To support VP-Finance's claim to review all, and not to post any, journal entries, Koeppel relied on two elements of the so-called journal entry control testing, which are described by Koeppel as "ensuring that the specific journal entries selected for testing" under AU § 316 "were created and signed off by the appropriate personnel" and "confirming that security access controls appropriately restricted access." KRB 8. The first again involved examination of the same binders of paper journal entry forms used for the journal entry testing, prepared and maintained by Koss's accounting department, from which items admittedly could have been excluded. *E.g.*, Tr. 795, 827, 1147, 1150, 1306 (Koeppel); *see* Exs. D-4 at 84-86 ("so seeing that we had things going from both directions and no exceptions were noted, it was deemed that we had everything…their policy of the binders and then tracing them back in the other direction, finding [no] exceptions, we relied on the representations from management that they had provided everything") & R-509 at 129 ("not finding any evidence that these [binders] were incomplete, we presumed that they were complete"), 147 ("[W]e did a sample of going from the [form] binders to the system [*i.e.*, the update reports] and the system to the [form] binders to verify completeness. Absent of exceptions, we deemed the binders to be complete and concluded our testing.") (Audit Manager's investigative testimony).

Koeppel's other asserted source of support for VP-Finance's claim is Koss IT system access controls, as Koeppel understood them from audit team inquiry, walkthroughs, and a 2006 user profile list. *E.g.*, Tr. 826, 1148-49, 1306; Ex. J-73 at 1, 2; Ex. R-509 at 99-100, 101-06. But Koeppel admits that such controls, too, could not provide evidence of whether journal entries were missing from both sets of paper binders. *E.g.*, Tr. 827 (acknowledging that there were not any controls that provided evidence that all the update reports were included in the paper binders), 1149 (same).

Further on access controls, only in the first of the three audits at issue was a list of user profiles obtained from the contractor to whom Koss outsourced management of its IT system. According to an unelaborated notation reviewed by Koeppel on the 2006 audit program, "IT provided a list of all user profiles. The user profile of 'Accounting' indicates the ability to post entries to the general ledger. Per review of the listing only [Senior Accountant] and [Junior Accountant] have this user profile." Ex. J-7, Ex. J-73 at 2. As Koeppel knew, the work step on the 2006 audit program to which the notation was appended stated, "Verify the completeness and accuracy of the [user profile] list by

with employment information they might provide, indicates that the expert's assumption is unwarranted, not least because fraud by VP-Finance beginning in 1997 predated the tenure of Senior Accountant and Junior Accountant in the accounting department. *See, e.g.*, Tr. 732, 1478, 1502; Exs. R-205 at 2, 5, R-396 at 1, 5; *see also SEC v. [VP-Finance and Senior Accountant]*, No. 10-CV-0747 (E.D. Wis.), Complaint filed Aug. 31, 2010, at 2-3 ¶¶ 8-9 (alleging VP-Finance held her position at Koss starting in 1992 but Senior Accountant did not hold her position at Koss until 2001), Senior Accountant's Answer filed Nov. 22, 2010, at 6 ¶¶ 8-9 (admitting or not denying those allegations).

comparing it to system controls." *Id.* Yet, as the notation indicated, all that done in this regard, in the words of Audit Manager's investigative testimony, was "obtain[ing]" and "look[ing] at" the list itself. *Id.* at 94-96, 101; Ex. J-9. According to that testimony, "we did not test the operating effectiveness of the[] controls" over access of Koss personnel to post journal entries and Koeppel understood this; Audit Manager did not gain an understanding of all of the user profiles that existed at the time in Koss's IT system, including whether anyone at the company had a "super user profile"; and Audit Manager could not identify any audit work performed to determine the completeness of the list or to test information the outside IT contractor used to generate the list. Ex. R-509 at 96, 100-02, 105-07, 110-13; Ex. D-4 at 53-57; *see* Tr. 535 (2007-2008 Staff/In-Charge Auditor: control effectiveness within Koss's IT system was not tested); *see also, e.g.,* AU § 319.77 (where the auditor does design tests of automated controls and, for example, identifies user review of a company report as a direct control related to an assertion, the auditor "should consider the effectiveness of the user review of the report and also the controls related to the accuracy of the information in the report"), .95 ("Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control.").

Otherwise in the audits in question, there is no claim or evidence that a user access list was even obtained, much less tested. Instead, general inquiries were made of the contractor about whether the IT system had changed, and in 2008 these inquiries were directed primarily to Koss's accounting department itself. *See* pp. 41-42 above.

Moreover, there is no evidence that the one user profile list obtained in the one audit purported to cover the entire fiscal year, rather than just the point in time at which it was generated, a matter Audit Manager testified in the investigation "would be important to know" in the audit. *E.g.,* Ex. R-509 at 97, 102. Audit Manager stated that "inquiry, observation, and," again relying on the paper binders, "the lack of exceptions noted in our sample testing" were the procedures performed in 2006 to verify that access to post entries did not change over time, yet she could not identify any inquiry into, or evaluation of, changes in VP-Finance's access. *Id.* at 99-106.

Also, Koeppel knew that "no review is done of the list of authorized individuals" by Koss. Ex. J-73 at 2. This was contrary to a 2004 recommendation by the Grant Thornton IT specialists. Ex. J-2 at 15. And the two cited reasons, given by VP-Finance, for Koss not doing a review were that "the list of individuals is so small" (Ex. J-73 at 2), which had been rejected by the IT specialists as "not a control when assessing the effectiveness of segregation of duties and user access controls" (Ex. J-2 at 16), and that she claimed she "reviews each journal entry that is posted" (Ex. J-73 at 2), which again depended for corroboration on the paper binders of journal entries. Similarly, Audit Manager found it necessary to repeatedly cite the audit work on the paper binders to try to fill gaps in the access controls work, such as the lack of procedures performed to determine the completeness of the user profile list in 2006 or to verify, for example, that VP of Finance's access did not change over the year. Ex. R-509 at 98, 100-03 ("We performed journal entry testing, found [no] exceptions to our understanding, and, as such, did not perform any further verification."), 105-06 ("Finding no exceptions, there was no need for the team to do anything further."), 110-12 ("The testing that we did was to look at the underlying journal entries and saw no exceptions and had no reason to believe anything further….We saw that there were two individuals that had that user profile [that had the ability to post journal entries] and, through the results of our testing found [no] exceptions, did not deem it necessary to do any further testing or inquiry."). As noted, Koss's outside IT contractor had no involvement with the monthly binders of journal entry forms and update reports, and the audits did not identify or test any controls over the creation and maintenance of the binders. *E.g.*, Tr. 99-100, 334-35, 827, 1473; Ex. D-2 at 30 (Division expert report: chart illustrating control risks involved).

Additionally, the 2004 IT review had brought to light that there were more than 50 accessible user profiles in Koss's IT system and only 20 users and had found that Koss "does not perform regular user access/segregation of duties reviews" and that "[a]s a result, some users may have excessive access to the Company's financial systems." Ex. J-1 at 5; Ex. J-2 at 12, 15-16. Koeppel also knew that management had, in effect, disregarded the IT specialists' concern about the lack of regular review of user access for "inappropriate access rights by department managers / vice presidents." *Id.* at 15-16. Further reducing the weight that could be placed on Koss IT controls were the specialists' findings discussed above, known to Koeppel during the audits in question, about Koss's outside IT contractors' focus on functionality and poor understanding or appreciation of IT control standards, Koss's heavy reliance on the contractors, Koss's "probably ineffective" controls for managing user access to its software system for certain key functions, and its lack of an audit perspective in looking at internal controls. Ex. J-1 at 1; Ex. J-2 at 1, 17-18; *see* Tr. 1483-86; *see generally, e.g.,* AU § 319.40.[35/]

[35/] Koeppel argues that this case does not present the situation, posited by her as common in her experience with small companies, in which the auditor learns that key management actually "has access to information or access to systems that they have never used" and, due to "the fact that the access still exists," reports it to the entity as "a control deficiency, or a significant deficiency." Tr. 1301; *see* KOB 27 n.17; KPHS 22. But that ignores whether, along with the other weaknesses in the control-related work, Koeppel failed (as we find she did) under the circumstances to address the risk of such access sufficiently to place the weight she does on Koss IT controls over journal entries. *See S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 WL 3339647, *2, *25 (July 3, 2013) (defect that "permeated [auditors'] problematic audit approach" was that, without sufficient attention to the particular circumstances, they "frequently relied on generalized experience from their past history with other clients to draw conclusions" about the financial statements under audit, "insist[ing] that the audit procedures they utilized in [the audits at issue] are the same procedures they have used in many other audits").

On the subject of access controls over posting journal entries, the June or July “walkthroughs” of individual transactions in the audits did not occur at month-end, when most journal entries were assertedly entered, and added little to the foregoing. That is, the walkthroughs consisted of receiving more mere assertions from members of Koss’s accounting department, taking note of a few past paper records of journal entries, and observing at the time that “A system log-on and password are necessary to access the [IT] system” (2006), that “[Senior Accountant and Junior Accountant] access the system by use of user names and passwords” (2007), and that a Koss staffer with accounts payables duties “entered her username and password to access AS 400, whereupon she did not have the authority to create and/or post journal entries” but Junior Accountant “did have such access” (2008). *See* pp. 38-39, 48 above; *see also, e.g.*, Tr. 690 (2007-2008 Staff Auditor: walkthroughs were based on inquiry, observation, and review of documentation). The fragmentary, limited information thus obtained through observation confirmed that at that particular point in time, Senior Auditor and Junior Auditor had access to post journal entries and one stray junior Koss staffer did not, but, contrary to Koeppel’s characterization (*e.g.*, Tr. 826, 1493), otherwise did not “test” that any access control had been placed in operation, much less was operating effectively, over posting or review of entries by, for example, VP-Finance or President/CEO.

Koeppel additionally claims to have understood that not only VP-Finance but also President/CEO was a “monitoring control” over the journal entry process. *E.g.*, Tr. 1305, 1448-51. Although Koeppel’s brief contends that President/CEO reviewed “‘all’” journal entries booked each month, partially quoting a sentence from each audit’s iteration of the financial reporting controls memo (KRB 8), there is no evidence that anyone read the memo to say that at the time of the audits, and whatever it stated was based on general assertions by members of Koss’s accounting department, the very people on whose conduct the monitoring was supposed to be a check and balance.

The sentence actually makes the compound statement that “[President/CEO] and [VP-Finance]” review the entries, and the statement was based on representations from VP-Finance and possibly Senior Accountant. *See* Exs. J-4 at 1, 2, J-101 at 1, 2, J-201 at 2; Ex. D-4 at 45-51. Another work paper stated instead that President/CEO “reviews [VP-Finance’s] journal entries through review of the monthly financial statements.” Ex. J-11 at 4. Koeppel testified that she generally understood that President/CEO, who was not an accountant by training and did not profess to be a GAAP expert, reviewed journal entries only on occasion, she could not recall him ever telling her that he reviewed journal entries monthly, she did not know how he would have conducted any review of individual entries, and she was not aware of any documentation of such a review. Tr. 1448-50. This is consistent with Audit Manager’s understanding, “through discussions” with the accounting department, that President/CEO “was involved in the process” and may have “go[ne] through those [same] journal entry binders” provided to the auditors, and with 2006-2008 Staff/In-Charge Auditor’s belief, again through mere assertions and not any observation or documentation, that, at most, President/CEO reviewed journal entries “on a topside” basis, “through review of the financial statements or through review of supporting documentation." *See* pp. 36-37 above. This is also consistent with testimony that it "would have been hard" and "a very time-consuming process" to "go through every journal entry posted in a month or a week or a year" on a Koss computer terminal because when Koss's accounting staff "pulled up transactions" on the screen "and when you got to the detail of the journal entry, they only were able to show that transaction." Tr. 415-16 (2006-2008 Staff/In-Charge Auditor). Indeed, in response to Grant Thornton's 2004 IT review, Koss management indicated that it placed great reliance on its departmental staff: "I think it is important to note our IT is in the hands of the users. Each area is responsible for it[s] data and the accuracy of that data." Ex. J-2 at 17. All of this, along with, for example, the lack of evidence of controls over the process of creating journal entries and of compiling the binders and the lack of evidence of automated controls over the journal entry review process, meant that, as far as the auditors knew, Koss's accounting department enjoyed a significant amount of autonomy in the initiation, preparation, review, recording, and memorialization of journal entries.

Not only did Koeppel lack enough direct, specific information about President/CEO's "active role" to place the weight she claims to have done on it as an internal control over journal entries (*see* Tr. 1221-22, 1305, 1311, 1448; *see generally* AU §§ 319.26, .36, .56), but he was also still a member of management, and so any reliance on him had to be tempered by a number of considerations. *See* AU § 316.45 n.19 ("an overall judgment about whether risk for the entity is classified as *high, medium*, or *low*" is "too broad to be useful in developing the auditor's response" to the assessment of the risks of material misstatement due to fraud). Specifically, as Koeppel knew, contributing to the inherent risk of fraud and the risks of management override of controls and lack of segregation of duties were the circumstances that "[t]he operating and financial decisions are dominated by a few individuals [at] Koss," an organization of "small size," which "preferred to put their dollars to [research] and development of products rather than internal systems," had no internal audit function, and operated in an industry with a "[h]igh degree of competition, accompanied by declining margins" and with "[p]ressure to meet expectations of analysts, creditors, and others" or revenue "targets." *See* Exs. J-3 at 2, 3, J-100 at 2, 3; Ex. J-200 at 1 ("Sales have been declining slowly over the past two years. This creates the risk that the Koss won't be able to sustain profitable bottom line."), 2, 3, 4; Exs. J-70 at 1, 2, 3, 4, J-178 at 1, 2, 3, 4, 5, J-278 at 1, 2, 3, 4; Exs. R-205 at 4, R-299 at 4, R-396 at 3; Tr. 1485-86 (Koeppel); Ex. R-509 at 62 (Audit Manager's investigative testimony).

As Koeppel also knew, contributing to the risk of fraud relating to revenue recognition was "the public company nature of Koss," that "revenues are closely focused on as a growth area" at Koss, which was "very revenue focused" and "actually posted in a public place revenues for a month and how far ahead [or] off target" it was, that President/CEO "was compensated on meeting goals and targets," and that VP-Sales "was compensated on revenues and on sales." Tr. 1274-75, 1286-87. In addition, the just-discussed findings by the firm's IT specialists further limited the reliance Koeppel could properly place on President/CEO as a control. For all of these reasons, the journal entry control-related procedures did not compensate for the serious flaw in the upstream/downstream testing used in the 2006, 2007, and 2008 Koss audits.

The remaining items Koeppel cites also did not provide any significant assurance about the completeness of the journal entry population subject to audit testing. The second item is that Koss had "a standard numbering system of which the engagement teams gained an understanding" and from which they "investigated any unexpected deviations," supposedly "provid[ing] additional comfort that they were dealing with a complete population of journal entries." KRB 7. But Koeppel acknowledges that "Koss's numbering system for its journal entries was not sequential" and that "gaps in sequential numbering" themselves "could not, therefore, identify missing journal entries." *Id.; see* Tr. 1322-23. So all the auditors' "[r]eview of the numbering of journal entries" and consideration of Koss's "use of consistent numbers for standard entries" (KPHS 30) could have accomplished was to identify internal inconsistencies in the numbering of the set of entries presented to the auditors.

This said nothing about whether entries were missing outside of that group: standard entries above, not below, the highest number represented in the binders in the range of 100 potential journal entry numbers per category, and nonstandard entries (which bore both a number and an indeterminate range of letters) above, not below, the respective bare journal entry number or combination of respective numbers and letters represented in the binders. By Koeppel's own description, there was no "use of consistent numbers" for nonstandard entries. The "standard numbering" audit work left an obvious blind spot for journal entries that may have been the most unusual and the most likely to exhibit characteristics of inappropriate entries, and this work therefore did not provide meaningful "additional comfort" about the completeness of the journal entry binders. *See, e.g.*, Exs. D-4 at 82-83 & Ex. R-509 at 94 (Audit Manager testified in the investigation about the importance of "looking for things that are unusual in nature and nonstandard" and of having a complete population to test because "you can't evaluate what's not there"); *see generally, e.g.,* AU § 316.61 (identifying characteristics that fraudulent journal entries often have and also noting that "[n]onstandard entries," such as "entries used to record nonrecurring transactions," "might not be subject to the same level of internal control" as "[s]tandard journal entries used on a recurring basis").

It is not clear how the third item cited by Koeppel is any more or better evidence of completeness of the journal entry binders than the second item. Simply making the point, as Koeppel does, that Koss printed update reports on multiple pages attached to each other by perforated edges ignores consistent testimony by her and multiple other audit team members that, while this might describe the pages of an individual update report, the update reports were separate from one another, journal entries could be entered at any time of the month, and journal entries could be entered singly or in batches, thereby generating separate update reports at different times. Tr. 770-71, 788-89 (Koeppel); Tr. 52-53, 90, 412-13, 417 (2006-2008 Staff/In-Charge Auditor); Tr. 555-57, 705-06 (2007-2008 Staff Auditor); Ex. R-509 at 118-20, 129 (Audit Manager's investigative testimony). Thus, merely because the pages of each update report that was given to the auditors by a member of Koss's accounting department may have been attached to each other by perforated edges said nothing about whether any number of other reports of single or multiple entries were omitted from the binders.

The fourth item urged by Koeppel is that Koss's outside IT contractor (criticized in the 2004 IT review) and accounting department members stated generally that "Koss's IT system generated an Update Report each time a journal entry was posted to Koss's general ledger," which she claims "provided additional support that the Update Reports represented a complete population of journal entries that had been entered to the general ledger." KRB 9. The only corroboration for these assertions was the other items Koeppel cites and, again, the upstream/downstream procedure. *E.g.*, Tr. 826-28, 1141-42. So the assertions lack detail and support. But more importantly, even assuming the contractor's depiction of Koss's computer system was correct, this does not mean all update reports that were printed were included in the binders, which was entirely the province of Koss's accounting department and over which process no controls were identified giving evidence of completeness. *E.g.*, Tr. 99-100, 334-35, 827.

The fifth and last of the items Koeppel cites consists of mere assertions by Koss's management and accounting department to the effect that they were not aware of any fraud at the company and that management had made available all "[f]inancial records and related data" and there were "no material transactions that have not been properly recorded in the accounting records underlying the financial statements" (*see* pp. 48-49 above). In light of the detailed evaluation we have just made of the audit work in the journal entry area of the 2006, 2007, and 2008 audits, Koeppel's reliance on these representations can only be viewed as treating them as "a substitute for the application of those auditing procedures necessary to afford a reasonable basis" for an audit opinion, in violation of AU § 333.02. Her extensive, excessive reliance on highly general and largely or entirely uncorroborated management representations likewise violated the bedrock principles that the auditor "neither assumes that management is dishonest nor assumes unquestioned honesty" and "should not be satisfied with less than persuasive evidence because of a belief that management is honest" (AU § 230.09); that the auditor "should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity" (AU § 316.13); and that "[i]n designing audit procedures to obtain competent evidential matter, [the auditor] should recognize the possibility that the financial statements may not be fairly presented..." (AU § 326.25).

After thus canvassing the audit work in the journal entry area, Koeppel appears to contend that this was the only way she "could have complied with AU § 316.61 under the circumstances." KOB 40. The apparent basis for such a claim is her view that the only alternative raised by the Division was accessing Koss's electronic general ledger through a Koss computer terminal, which she argues would have been "mediated in at least two respects" ("first, by the software and commands that were used to make particular journal entries appear on the computer monitor" and "second, by [Senior Accountant's] participation in the process") and been no better than the paper binders, and her view that the cited firm journal entry training materials "did not identify an alternative method that could have been used at Koss." KOB 15-16 n.10, 22-23 & n.14, 40; KPHS 31-32, 70. According to Koeppel, she was simply "rely[ing] on the firm's guidance," through "consult[ing] with several senior partners" about the PCAOB inspection comment on the 2005 Koss audit, "concerning how to address completeness of the journal entry population at Koss." KOB 15, 23 n.14, 40; Tr. 1451-55.

There is no merit to these arguments. At the hearing, Koeppel acknowledged that it was she who was ultimately responsible for conducting the Koss audits in accordance with PCAOB standards. Tr. 1438. It was Koeppel who decided not to pursue the discussion with the Grant Thornton partners beyond the general idea of "upstream/downstream testing" and who never asked anyone outside of the audit teams to review the remedial work on the 2005 audit or the different "upstream/downstream testing" used in 2006, 2007, and 2008 before authorizing issuance of the audit reports for those years, because she "did not see a need to elevate that to somebody outside of the engagement team." Tr. 766-71, 1452-55, 1491-92. Nor did Koeppel even engage with Audit Manager about the particular methods Audit Manager chose to use for the upstream/downstream testing in the various Koss audits. Tr. 768-71, 1491-92.

Koeppel also made no effort to secure the assistance of a professional with specialized IT skills or apply computer-assisted techniques to try to obtain a complete population of journal entries for fraud testing or to help access Koss's electronic general ledger by computer terminal to test entries. *See, e.g.*, Tr. 1324. Koeppel knew that, as Audit Manager testified in the investigation, no alternative procedures were performed to test the completeness of the journal entries in the binders by, for example, reconciling the beginning and ending balance for any general ledger account using the update reports for the fiscal year. *See, e.g.*, Tr. 1334-35; Exs. D-4 at 127 & R-509 at 127-28, 179. And Koeppel chose not to test internal controls. Tr. 1254-57, 1336, 1473.[36/]

[36/] *See generally* AU §§ 319.04 ("the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level"; "[w]hen evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form, the auditor's ability to obtain the desired assurance only from substantive tests would significantly diminish"), .65, .66 ("the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions"), .67 ("[i]n determining whether assessing control risk at the maximum level or at a lower level would be an effective approach for specific assertions, the auditor should consider," among other things, "[t]he nature of the available evidential matter, including audit evidence that is available only in electronic form"), .68 ("In circumstances where a significant amount of information supporting one or more financial statement

Furthermore, PCAOB standards stress that "[t]he auditor's response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence" and that examples of application of professional skepticism in response to the risks of material misstatement due to fraud are "designing additional or different auditing procedures to obtain more reliable evidence in support of specified financial statement account balances, classes of transactions, and related assertions" and "obtaining additional corroboration of management's explanations or representations concerning material matters, such as through third-party confirmation, the use of a specialist, analytical procedures, examination of documentation from independent sources, or inquiries of others within or outside the entity." AU § 316.46; *see* AU § 316.02 ("the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence"), .13 ("Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud."), .16 (recognition of "the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit" should lead auditors "to thoroughly probe the issues, acquire additional evidence as necessary, and consult with other team members, and, if appropriate, experts in the firm"). The auditor "should be thorough in his or her search for evidential matter and unbiased in its evaluation." AU § 326.25. The difficulty and expense that may be involved in testing a particular item "is not in itself a valid basis for omitting the test." AU § 326.24.

PCAOB standards require the auditor "to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of the auditing procedures and other observations affect the assessment." *See* AU § 316.02. The auditor's responses to address specifically identified risks of material misstatement due to fraud "may include changing the nature, timing, and extent of auditing procedures in the following ways:

assertions is electronically initiated, recorded, processed, or reported, the auditor may determine that it is not possible to design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated. For such assertions, significant audit evidence may be available only in electronic form. In such cases, its competence and sufficiency as evidential matter usually depend on the effectiveness of controls over its accuracy and completeness."), 326.14 ("In entities where significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions….In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk[] or consider the effect on his or her report (see paragraph .25 of this section).").

The *nature* of auditing procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information….The *timing* of substantive tests may need to be modified." For example, the auditor "might conclude that substantive testing should be performed at or near the end of the reporting period to best address an identified risk of material misstatement due to fraud (see section 313, Substantive Tests Prior to the Balance Sheet Date). That is, the auditor might conclude that, given the risks of intentional misstatement or manipulation, tests to extend audit conclusions from an interim date to the period-end reporting date would not be effective." AU § 316.52. An option might be "[r]equesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period." AU § 316.53; *see* AU §§ 316.54 (if an identified risk of material misstatement due to fraud affects inventory quantities, "it may be appropriate for inventory counts to be conducted at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period"), 319.82 (to increase the assurance from substantive tests, the auditor may "[c]hange the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity," "[c]hange the timing of substantive tests, such as performing them at year end rather than at an interim date," and "[c]hange the extent of substantive tests, such as using a larger sample size").

The standards further provide that "[i]f the auditor is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though management has given representations concerning the matter, there is a limitation on the scope of the audit, and the auditor should qualify his or her opinion or disclaim an opinion." AU § 333.14. To the extent the auditor "remains in substantial doubt about any assertion of material significance, he or she must refrain from forming an opinion" until she had "obtained sufficient competent evidential matter to remove such substantial doubt" or "express a qualified opinion or a disclaimer of opinion." AU § 326.25; *see* AU § 319.28 ("Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements."). The auditor may even "conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud," in which case "withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action." AU § 316.49; *see* AU § 316.78 ("consideration of the risks or material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility"). We reject any notion that Koeppel had no choice but to accept the inadequate journal entry testing without doing anything more.[37/]

Finally, Koeppel advances the unavailing procedural argument that the initial decision "misapplied the burden of proof" in the journal entry area because it noted that the part of AU § 316.61 with which it found noncompliance uses the word "should" ("the auditor's procedures should include selecting from the general ledger journal entries to be tested and examining support for those items") and that PCAOB Rule 3101(a)(2) states that "should" in the Board's auditing standards "indicates responsibilities that are presumptively mandatory." KOB 40 (citing I.D. 32, 36); KRB 5-6, 9. Presumptively mandatory, in turn, means that failure to discharge that responsibility "is a violation of the relevant standard and Rule 3100" unless the auditor "demonstrates that, in the circumstances, compliance with" that responsibility "was not necessary to achieve the objectives of the standard" and that "alternative actions he or she followed in the circumstances were sufficient to achieve [its] objectives." Rule 3101(a)(2).

Even if Koeppel's parsing of language in the initial decision did support her claim of error, it is the Board's decision, on *de novo* review, that governs. *See, e.g., Kabani & Co.*, SEC Rel. No. 34-80201, 2017 WL 947229, *8 n.7 (Mar. 10, 2017) (if further review

[37/] At oral argument, Koeppel's counsel also broadly argued that because, in his view, "throughout those three years" the "test work that was done" on pertinent Koss financial statement accounts hit by the journal entries "didn't raise any issues with respect to any of those journal entries" and "did not identify any journal entries on the other side that raised any questions," this supports the journal entry testing. ArgTr. 63, 64, 67-68. That vague, general claim was a frequent refrain in Audit Manager's investigative testimony (Exs. D-4 at 86 & R-509 at 127-28, 131-34, 179) and was made at the hearing by 2006-2008 Staff/In-Charge Auditor (Tr. 82-83, 107-08). But, as noted, AU § 316.61 requires a particular focus on the fraud risk of management override of controls. Indeed, AU § 316.42 specifically provides that "the auditor should address that risk (see paragraph .57) apart from any conclusions regarding the existence of more specifically identifiable risks." Furthermore, identified risks of material misstatement due to fraud are not interchangeable with identified inherent risks generally (*see, e.g.,* AU § 316.34) and may be "related to specific financial-statement account balances or classes of transactions and related assertions" or they may "relate more pervasively to the financial statements as a whole" (AU § 316.38). In addition, "audit procedures that are effective for detecting an error may be ineffective for detecting fraud." AU § 316.12; *see, e.g.*, AU § 316.31 ("Because fraud is usually concealed, material misstatements due to fraud are difficult to detect."). Ordinary substantive testing of financial statement accounts cannot simply be assumed to be comparable to proper fraud testing of journal entries, and, in particular, does not address a completeness problem with the latter when, as discussed in later sections, the account testing is itself characterized by inadequate audit work on the completeness of the entity information on which it rested.

is sought in a PCAOB disciplinary proceeding, it is "only the Board's decision on appeal" that the SEC reviews); *Richard G. Cody*, SEC Rel. No. 34-64565, 2011 WL 2098202, *19 (May 27, 2011) (alleged error in earlier stage of administrative proceeding does not taint a later decision based on *de novo* review in the matter if there is no evidence that such error factored into that decision and sufficient evidence supports the decision), *aff'd*, 693 F.3d 251 (1st Cir. 2012); *mPhase Technologies, Inc.*, SEC Rel. No. 34-74187, 2015 WL 412910, *8 (Feb. 2, 2015) (same); *Robert Tretiak*, SEC Rel. No. 34-47534, 2003 WL 1339182, *10 (Mar. 19, 2003) (same); *Frank J. Custable*, SEC Rel. No. 34-33324, 1993 WL 522322, *6 (Dec. 10, 1993) (same); *Stephen Russell Boadt*, SEC Rel. No. 34-32905, 1993 WL 365355, *2 (Sept. 15, 1993) (same, citing *Dillon Sec., Inc.*, SEC Rel. No. 34-31573, 1992 WL 383783, *7 n.29 (Dec. 8, 1992) (collecting cases)). Suffice to say, our *de novo* review of the record includes consideration of any evidence offered by the parties about whether, in the circumstances, compliance with AU § 316.61, and any other presumptively mandatory responsibility at issue, was not necessary to achieve the objectives of the standard and whether alternative actions followed in the circumstances were sufficient to achieve its objectives. In this, as in other regards, the Division bears the burden of proving by a preponderance of the evidence that Koeppel engaged in an act or practice, or omitted to act, in violation of PCAOB rules and auditing standards, as charged in this proceeding. PCAOB Rule 5204(a).[38/]

Accordingly, we find that Koeppel violated AU §§ 110 and 316.61 and also failed under AU § 230 to exercise due professional care, including professional skepticism, with respect to the journal entry testing.

[38/] For the record, it is apparent from the initial decision that the hearing officer did not engage in "an improper shifting of the burden of proof from the Division to the Respondent." KOB 40. Rather, the initial decision applied PCAOB rules and auditing standards in a manner that at times correctly identified what those rules and standards required of the audit work but at other times mischaracterized the charges in a way that either imposed extra elements on the Division that it did not need to prove (*see, e.g.*, DOB 26) or relieved the burden of full compliance with particular auditing standards (*see, e.g.,* I.D. 48 (incorrectly stating that "unlike the journal entry testing discussed above, PCAOB auditing standards do not expressly provide that the auditor 'should' perform a reconciliation or any other specific procedure to obtain evidence that an Interim A/R Aging Report is complete and accurate," ignoring, for example, the decision's own quotation two pages earlier of AU § 350.24 in resolving the pertinent AU § 326 charge). Koeppel is thus simply trying to leverage those instances in which the initial decision erred in this regard into an argument that when the initial decision correctly applied the rules and standards it "misapplied the burden of proof" (KOB 39).

3. The revenue-related accounts

a. Net sales

In the net sales area of the 2006, 2007, and 2008 Koss audits, Koeppel relied on analytical procedures as "substantive test[s] to obtain evidential matter about particular assertions related to account balances or classes of transactions" (AU § 329.04.b; *see* AU § 329.09-.22). *See* p. 50 above. Koeppel has indicated broad, contemporaneous familiarity with the analytical procedures performed, specifically signed off on enough of the work papers to show that she knew the approach being taken to the procedures, and approved the larger audit approach of which they were a part. *See id.* For multiple reasons, the procedures did not provide the necessary level of assurance about the occurrence and valuation of Koss's net sales, and in relying on them to form her audit conclusions and authorize issuance of the unqualified opinions without performing necessary further work, she violated AU §§ 150, 230, 326, and 329.

The auditor "obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources." AU § 329.16. Such data can include "[f]inancial information for comparable prior period(s) giving consideration to known changes." AU § 329.05. The precision of the expectation depends in part on the "consideration of factors that significantly affect the amounts being audited." AU § 329.17. Expectations developed in analytical procedures used as substantive tests "should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate." AU § 329.17. Expectations "developed at a detailed level generally have a greater chance of detecting misstatements of a given amount than do broad comparisons." AU § 329.19; *see* AU § 316.56 ("the use of substantive analytical procedures, such as the development by the auditor of an expected dollar amount at a high level of precision, to be compared with a recorded amount, may be effective in certain circumstances" in response to a risk of material misstatement due to fraud relating to misappropriation of assets); note 42 below.

Furthermore, the reliability of the data used to develop the expectations "should be appropriate for the desired level of assurance from the analytical procedure." AU § 329.16. AU § 329.16 provides that "[b]efore using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information." AU § 329.16 further provides that the auditor "should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data." And AU § 329.16 identifies a number of factors that "influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives": (1) "Whether the data was obtained from independent sources outside the entity or from sources within the entity"; (2) "Whether sources within the entity were independent of those who are responsible for the amount being audited"; (3) "Whether the data was developed under a reliable system with adequate controls"; (4) "Whether the data was subjected to audit testing in the current or prior year"; and (5) "Whether the expectations were developed using data from a variety of sources." In delineating several presumptions "about the validity of evidential matter in auditing" that may "have some usefulness," AU § 326.21 echoes that the first and third points listed in AU § 329.16 can each provide greater assurance about the reliability of accounting data and financial statements, and adds, "The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly."

Relevant to the desired level of assurance, the parties disagree about the role of the net sales analytical procedures in the audits. The Division stresses that Koeppel "intended to use the analytical procedures" as "substantive testing to support the occurrence and valuation of Koss's net sales," yet, in the Division's view, those procedures "were not substantive tests in compliance with AU § 329.09-.21," capable of providing the necessary evidential matter, due to insufficiently precise expectations and inadequate support for the reliability of the underlying information. *E.g.*, DOB 6, 17 n.69, 28, 30, 32-33; DRB 23-25; DPet. 2 & n.3, 4, 5, 8, 9; DPHS 73, 76-78; *see, e.g.*, OIP 13-14 ¶¶ 41-43. Before us, the Division does not seem to challenge the initial decision's point that, consistent with the "transaction cycle" approach to the audits described by Koeppel (*see, e.g.*, Tr. 1363), accounts receivable testing "constitute[d] evidential matter relevant to Koss's net sales assertions" (I.D. 60). *See* DRB 24. As the initial decision explained, quoting a Koeppel expert, "'Audit procedures using a cycle approach recognize that confirmation of accounts receivable provides evidence not only that the receivable exists, but also that the sale occurred.'" I.D. 59; *see* Tr. 877 (Koeppel). But the Division defends the initial decision's conclusion that, even so, the analytical procedures were "the principal substantive tests of Koss's net sales assertions" (I.D. 60). *E.g.*, DRB 22-23.

Koeppel, for her part, claims that "tests of details performed on accounts receivable constituted the principal audit procedures supporting the valuation and occurrence of net sales" and, in particular, describes "the tests to confirm accounts receivable" as "the other substantive procedures performed to test net sales," in addition to the analytical procedures. *See, e.g.,* KRB 10 & n.3, KPHS 33, 71-72; *see also, e.g., id.* at 73, 75; KOB 44, 45; Ex. R-507 at 75 (Koeppel expert report, describing "[t]he confirmation procedures performed with respect to invoices outstanding in accounts receivable as of April 30 of each year" as "especially important" source of evidential matter for Koss's net sales); Tr. 2070 (Koeppel expert: "the accounts receivable confirmations were the primary test").[39]

The initial decision found that "the work papers do not indicate that the A/R testing was intended to be the principal testing of Koss's net sales." I.D. 60 (emphasis in original); *see, e.g.*, Exs. J-123 at 3, J-220 at 45 (2007, 2008 accounts receivable sample testing work papers, stating simply for "Conclusion" that "Based on the above testing, GT notes AR is fairly stated at 4/30/07" or "Based on above testing, GT concludes that A/R is fairly stated at 4/30/08"); Exs. J-16 at 3, J-110 at 2, J-210 at 1 (2006-2008 revenue audit programs, which include but do not address the respective weight of the confirmation procedure). For documentation in support of her claim, Koeppel points only to Grant Thornton audit manuals stating generally that the "transaction cycle" approach "permit[s] us to account for the interrelationships among audit procedures and assertions for income and expense accounts and corresponding elements of the balance sheet." *E.g.*, Ex. J-60 at 13, cited by KOB 44-45.

Even if we assume that, in Koeppel's judgment, the principal substantive test in each audit of Koss's net sales was the accounts receivable testing, we nonetheless conclude that the analytical procedures were important tests of Koss's net sales. As the initial decision noted, "Koeppel does not contend that the A/R procedures by themselves provided 'sufficient competent evidential matter' as to Koss's net sales assertions." I.D. 59-60. Indeed, at one point, a Koeppel expert witness indicated in his report that "test of details in the form of accounts receivable confirmations" and "analytical procedures for testing revenue-related accounts" were, in combination, "[t]he principal audit procedures for the revenue cycle." Ex. R-507 at 61. Grant Thornton audit manuals for the relevant period explained that the "B" strategy, which Koeppel testified was applied in the revenue and inventory areas of the audits, "emphasizes analytical procedures on income statement accounts and tests of details for balance sheet accounts," even as it "requires analytical procedures to be augmented with tests of details." *See* p. 15 above. As she testified, under that strategy, "We focused on tests of details of the balance sheet and analytics as it relates to the income statement." Tr. 1353; *see, e.g.,* Tr. 1263 (Koeppel stated that firm's proprietary software automatically designed procedures tailored to the B approach, "provid[ing] a summary of procedures that focus on test of details for the balance sheet and a variety of analytics addressing the income statement"); Tr. 689 (2007-2008 Senior Auditor understood that the strategy required testing of critical assertions in the income statement by substantive analytical procedures). Accordingly, no detailed lists of Koss's gross sales or contrarevenue items

[39] Although "the testing of co-op allowances was one of the pieces of audit evidence relied upon to support the valuation of revenues" (Ans. 31 ¶ 74), Koeppel does not identify those procedures as being as significant a part of the net sales audit work as the analytical procedures. *See, e.g.*, KRB 10 & n.3. In fact, the sales allowance procedures did not test the underlying recorded sales transactions themselves and, as we discuss later, were deficient under PCAOB auditing standards.

(those subtracted from gross revenue to arrive at net revenue) were obtained for testing in the Koss audits. *See, e.g.,* Tr. 964-65, 1013-14, 1081-83; pp. 50, 56 above.

The limitations of the accounts receivable testing reinforce the importance of the analytical procedures. The number of confirmations to send was based on the accounts receivable balance, not the amount of the annual sales. See Exs. J-30 at 1, J-124 at 1-2, J-220 at 1-2. In each audit, the population of receivables from which a sample was selected for confirmation testing—approximately $9.3 million in 2006, $6.8 million in 2007, and $4.7 million in 2008, respectively—included only receivables remaining on Koss's balance sheet as unpaid as of the interim date of April 30. Consequently, of the total gross sales Koss recorded for the fiscal year—approximately $55.3 million for 2006, $50.4 million for 2007, and $52.3 million for 2008—only a small fraction (about 16.8%, 13.5%, and 9%, respectively) had a chance of being selected for the confirmation testing. *See* p. 64 above; *see also* DRB 24 (referencing Division expert witness's illustration of the limited scope of the confirmation testing, based on using Koss's gross accounts receivable at fiscal year end as a proxy for the size of the population from which the sample for the testing was drawn at interim and dividing by Koss's fiscal year net sales, to arrive at 16% for 2006, 19% for 2007, 24% for 2008).

Although Koeppel claims the Division "cannot seek to reargue th[is] point here" because the hearing officer "expressly rejected" it and the Division "did not seek review of that finding" (KRB 10 n.3), she is incorrect. The Division's position is that the accounts receivable confirmation procedures, even if correctly performed, provided "little or no" support for the occurrence and valuation of the "over three quarters of Koss's net sales" not subject to those procedures. DRB 24; DPHS 43. Koeppel mischaracterizes that argument as instead the blanket contention that those procedures "could not provide support for the occurrence and valuation of Koss's net sales" at all, and mischaracterizes the initial decision as having "expressly rejected" the argument that "the confirmation testing 'related to only a fraction of Koss's net sales,'" simply because the initial decision stated that, to some extent, this testing "constituted evidential matter relevant to Koss's net sales assertion" (KRB 10 n.3).[40/]

[40/] A Koeppel expert witness had purported to take issue with the Division's point, asserting that accounts receivable confirmation testing "applies not only for the sales that are uncollected" as of the date selected for the testing but "for sales for the entire [fiscal-year] period" up to that date. Ex. R-507 at 89-90; *see* Tr. 1899-1901, 2078-79. But her expert's argument was not that the confirmations tested any sales other than those represented in accounts receivable at the time, but rather that any other sales recorded by that point in the fiscal year would be covered by other testing of other accounts than sales or receivables: "Thus, accounts receivable confirmations test not only for sales around [the date selected for testing] but for sales recorded at any time that still remain in accounts receivable [as of that date]. To the extent sales no longer remain in accounts receivable, they have either been collected or moved to other accounts that are subject to other audit testing." Ex. R-507 at 91; *see* Tr. 1901-02

Moreover, because the confirmation testing was performed as of an April 30 interim date, none of Koss's May and June sales transactions, totaling between some $8 million and $9 million in each of the three fiscal years, was covered by that testing. *See* Exs. J-31 at 1, 2, J-125 at 1, 2; Ex. J-18 at 1; Exs. J-25 at 1, J-118 at 1, J-214 at 1; Ex. J-213 at 1-2. And the 2006 and 2007 accounts receivable rollforwards, which were meant to cover the remaining period, included no or little direct detail testing of sales activity in May and June, depending instead on the comparison of the overall accounts receivable balance, representing millions of dollars of offsetting items, from an April 30 trial balance report, adjusted using subledger reports of May and June activity, with a June 30 trial balance report. *See* pp. 66-69 above; *see also, e.g.*, Ex. R-509 at 156-62, 170-73 (Audit Manager's investigative testimony). To the extent, as Koeppel theorizes, the 2008 audit relied in part on the analytical procedures to compensate for the lack of any accounts receivable rollforward that year, that would only heighten the importance of those procedures in that audit. *See, e.g.*, Tr. 1365; KOB 50; KRB 13. And although

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("your satisfaction with the remaining accounts receivable provides assurance not only to the sales that make up those accounts receivable, but all sales throughout the year, simply because once they put it in accounts receivable, to get it out, you're—you're testing for that in various ways"). The expert thus did not contest the limited scope of the confirmation testing itself, even if properly performed, as a test of Koss's net sales.

In addition, that expert's rudimentary discussion of "other audit testing" that would apply where Koss had "put [an item] in accounts receivable" and "got it out" did not address the rigor and importance of that other testing relative to the desired level of assurance from the net sales analytical procedures, much less address that sales can be misstated without making any entry in accounts receivable, that fraudulent entries can balance without having any logical, realistic relationship to one another, and that a fraud can be spread out over multiple income statement or balance sheet accounts at the same time. The expert gave the cash account as an example of a relevant other account that would have been tested. But, unlike revenue, cash was not designated as a "critical cycle" in the Koss audits; no walk-through was performed with respect to it; it was not subject to any of Grant Thornton's "three main [audit] strategies," including the "B" strategy applied to Koss's "critical assertions" in the revenue area, but only to the "D" strategy, which consisted of "less extensive substantive audit procedures" and "concentrate[d] on techniques such as inquiry and analytical procedures to identify items that warrant detailed examination"; and the audits "did not tailor[] in specific procedures" related to VP-Finance having custody, authorization, and recordkeeping responsibilities for cash. Exs. J-15 at 1, J-109 at 1, J-209 at 1; Exs. J-60 at 21, J-139 at 24-25, J-269 at 20; Tr. 1136-40, 1476 (Koeppel); Ex. R-509 at 60-61 (Audit Manager's investigative testimony). For example, no testing was done of the exercise of check-signing authority by Koss's accounting department or whether or how its reconciliations of the cash account to the general ledger were reviewed by President/CEO, on whose oversight Koeppel testified she generally placed great reliance. *See, e.g.*, Tr. 1197, 1219-23, 1305, 1311, 1448-51; Exs. D-4 at 63-64, 67, 69-72 & R-509 at 58-61, 80.

each audit also included cut-off testing around the April 30 and June 30 dates of a total of about a dozen product shipments identified on Koss system-generated reports and the scanning of other such reports for large or unusual items in the last week or month of June, no procedures were applied to any of those reports to evaluate their reliability and the work was not significant enough in scale or scope to contribute sufficient additional audit evidence about the sales not subject to the confirmation testing. *See, e.g.,* pp. 50, 56-57, 65-68 above; *see also* Ex. D-2 at 64-65 (report of Division expert).

Furthermore, as Koeppel recognized, more was necessary to address Koss's net valuation of sales than audit work on Koss's gross sales. Tr. 964, 1014, 1082. Yet, as she knew, no effort was made in the accounts receivable testing in any of the audits to, for example, confirm with customers the terms or amounts of any sales allowances they might have received from Koss. Tr. 1404-05; *see* Ex. R-509 at 174-78 (Audit Manager's investigative testimony). And the 2006, 2007, and 2008 work papers for the confirmation procedure document only a combined total of a few instances in which the auditors reviewed a debit memo (a sales allowance claim) and around a dozen instances in which alternative audit procedures used when a receivable was not confirmed involved matching the unconfirmed amount to a credit memo (a sales allowance granted by Koss), in the case of one customer identifying the type of allowance ("coop allowance") and in a number of cases noting that the credit memo was issued after the confirmation date. Exs. J-30 at 1-2, J-123 at 1-8, J-220 at 44-46.

Finally and separately, the discussion thus far about net sales assumes that the audit work on accounts receivable was adequate under PCAOB standards even to test accounts receivable. As we find in the later section, that was not the case.

Despite the level of assurance indicated by the importance of the net sales analytical procedures in the audits, those procedures were, as the initial decision found (I.D. 62-63), characterized by "vaguely expressed expectations of changes" from prior period financial information that reflected a lack of detailed consideration of known changes to that information and "provided little assistance" in "identifying potential misstatements for further investigation." *See* pp. 52-53 above. Koeppel does not deny the vagueness of the expectations, instead making the argument, which we have rejected, that they did not need to be any more specific under the circumstances.

Additionally, two analytical procedures, to which Koeppel devoted substantial attention in each of the audits and which were intended to be more precise than other trend analyses (*see* pp. 53-55 above), provided less than the necessary level of assurance due to insufficient audit work to determine the reliability of the information used in the procedures. Specifically, the procedures compared current and prior-year annual and monthly sales amounts that Koss recorded by product line, using reports generated by Koss's IT system. As she explained, "breaking [the sales data] down by more than just account level" and "mov[ing] from looking at it on account basis to quarterly, also looking at it on a monthly basis" was undertaken in the Koss audits "[b[ecause disaggregation is more precise." Tr. 1382. In developing expectations, "[m]onthly amounts will generally be more effective than annual amounts and comparisons by line of business usually will be more effective than company-wide comparisons." AU § 329.19; *see* AU §§ 316.30 (results of analytical procedures that "use data aggregated at a high level," typical at audit planning stage, "provide only a broad initial indication about whether a material mistatement of the financial statements may exist"), .52 (extent of audit procedures applied "should reflect the assessment of the risks of material misstatement due to fraud…performing analytical procedures at a more detailed level may be appropriate"), .53 (example of modification of substantive audit testing in response to identified risks of material misstatement due to fraud is "[p]erforming substantive analytical procedures using disaggregated data," such as "comparing gross profit or operating margins by location, line of business, or month to auditor-developed expectations"), .54 (potential response to fraud risk involving revenue recognition is "[p]erforming substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods"). But the reliability of the disaggregated amounts matters to achieving the purpose of using disaggregated data in the first place. *E.g.*, Tr. 987-88, 1067-68 (Koeppel: consistency of the product line groupings was a fundamental question that needed to be asked when performing such a variance analysis, though she was not specifically aware of it having been asked during the audits). Otherwise, the auditor is simply making mathematical comparisons from one report to another of categories of disembodied numbers not necessarily tied to the entity's underlying accounting records.

At the hearing, Koeppel stated she understood during the Koss audits that Koss's management used a consistent methodology to allocate sales to the various accounts shown on the reports used in the audit testing. According to Koeppel, she "understood during each audit that the customer master file," a Koss IT system database, "assigns a customer to a particular sales category" and further understood, based on the walk-throughs of individual revenue-related transactions, that Koss had put controls in place that limited the authority and access of Koss personnel to change customer masterfiles. Tr. 1295 (observation was made in walkthrough, Ex. R-300 at 19, that Junior Accountant had update access and Senior Accountant had read-only access); *see* Tr. 362-63 (2006-2008 Staff/In-Charge Auditor); Exs. J-6 at 1, J-203 at 1 (2006 and 2008 Revenue Procedures Memorandum, reviewed by Koeppel, asserting, based on inquiry of Koss's accounting department, that customer masterfile was maintained by Junior Accountant, that any changes to it were reviewed by Senior Accountant, and that "the system will only allow authorized users to make changes to the masterfile" and "[a]ccess is limited by the use of user ID's and passwords"). A work paper from the 2006 audit described a journal entry as having been "done to record sales each month among the sales categories," and Koeppel acknowledged testifying in the investigation that this meant that the sales involved were allocated to the various sales categories by manual journal entry posted by Koss's accounting department. Ex. J-11 at 5; Tr. 957-

61. She insisted at the hearing, however, that during the audits "my understanding was it [the allocation] was done by the system," not generated by manual journal entries. *Id.*

Even if Koeppel had this understanding, she testified the approach applied by her in the Koss audits did not include any specific testing of whether sales were, in fact, consistently allocated among the product line accounts or between the periods of the year. Tr. 961-65, 987-90, 1010-13, 1066-68, 1080-83; *see* Tr. 220-21 (2006-2008 Staff/In-Charge Auditor). For example, the auditors did not obtain, much less examine, any detail listings of the transactions in those accounts. Tr. 962, 965, 1082-83; Tr. 150-52, 196. Koeppel's audit approach focused on comparing the same reports from one year to the next (*e.g.*, KPHS 80), not on whether, for example, as referenced by AU § 329.16, the reports were developed under a reliable system with adequate controls or whether the reports themselves were subjected to audit testing in the current or prior year. *See, e.g.,* Tr. 1336 ("We audit the output of the system, rather than the system itself."), 1473 ("we did not perform detailed tests of controls over IT") (Koeppel); KPHS 21 ("the Division's characterization of the 'obtain evidence' requirement [in AU § 319.65, as to the completeness and accuracy of entity system-generated data] as a 'testing' requirement misstates what is required"). No audit procedures were applied to the reports to support the completeness and accuracy of any of the current- or prior-year disaggregated amounts. *See* pp. 54-55 above. Testing the total amount of sales in auditing the financial statements thus did not include testing the disaggregated sales amounts, which was supposed to contribute to the testing of the total sales amounts.[41/]

For these reasons, the analytical procedures used to test the occurrence and valuation of Koss's net sales did not provide the necessary level of assurance.[42/]

[41/] Koeppel argues that prior year amounts that were used to establish the expectations for use in these two analytical procedures "had been subjected to audit testing," which is a factor under AU § 329.16 that influences the auditor's consideration of data reliability, and argues that, under AU § 329.16, the auditor "needs to address the reliability of the data used to develop the expectation," whereas "[t]he recorded amount is tested through the analytical procedure itself." KPHS 26-27. But this argument is unavailing. By her own account of the approach she and her audit assistants took to the Koss audits, presented as longstanding and fundamental and borne out on the record of the audit work, no additional procedures had been performed in the prior year than were undertaken in the current year with respect to the reliability of the reports used in these two analytical procedures. *See, e.g.*, Tr. 932-33, 1092, 1100-01, 1107-09, 1187-88, 1339-40, 1409-11, 1498; Ex. R-507 at 14 (Koeppel expert report).

[42/] Koeppel has asserted that the analytical procedures included in the audit work papers must be "considered as a whole." KPHS 75. But she fails to explain how, under the circumstances, any other of the analytics compensated for the serious weaknesses in the multiple analytical procedures on which the initial decision focused and which we have just discussed. It would not necessarily preclude the other analytics from taking

Koeppel's reliance on the above procedures in the 2006, 2007, and 2008 audits, in forming and authorizing the issuance of unqualified audit opinions, without having directed anyone else to perform, and without herself performing necessary additional audit work, violated AU §§ 150, 230, 326, and 329.16 & .17.[43/]

on added significance that, overall, most of the analytics were trend analyses, and, except for the returns reserve testing, the rest were ratio analyses. But the Division's expert did note, for example, that generally "'ratio and trend analyses are relatively imprecise and should be performed at a disaggregated level when higher levels of assurance are desired.'" Ex. D-2 at 51, quoting *AICPA Audit Guide: Analytical Procedures* ¶¶ 2.13 (2001) and citing AU §§ 329.19 and 150.06 ("The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.").

Most of the analytical procedures were not disaggregated. *E.g.*, Ex. D-4 at 119, 125 (Audit Manager's investigative testimony: "When it came to the ratio analyses and looking at the [trends] and the revenue ratios, those are done at the consolidated level" and constituted "[t]he majority of our analytics"; it was only secondarily, "[w]hen we got to looking at just the income statement and looking at line item variation analysis," that the procedures ceased to be "done at the consolidated level."). In response to the Division's expert, Koeppel does not specify how any particular, distinguishing characteristics of any of the other analytical procedures would have neutralized the flaws in the analytical procedures that form the basis for the violations we find here, nor does she identify any audit work applied to Koss IT-system-generated reports used in that testing that would do so. Some analytical procedures applied to inventory, not revenue, and Koeppel does not contest the Division expert's point that some of the revenue-related procedures provided little or no support for net sales. *See* p. 51 above (citing Ex. D-2 at 61). According to Koeppel's own expert, more than half of the analytical procedures in the record were prepared for quarterly reviews and "were never intended to meet the criteria for analytical procedures performed in annual audits under AU § 329." Ex. R-507 at 91. The inadequate audit response to the risk of management override of controls, discussed above, casts further doubt on the overall utility of the analytical procedures for purposes of her arguments here. *See* AU § 329.10 (override "might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements" and "might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions"). This problem is only compounded where, as here, it occurs over multiple years and "many of the expectations used in [the] analytical procedures are derived, at least initially, from prior year balances" (Ex. R-507 at 77).

[43/] With regard to the revenue-related analytical procedures, the OIP additionally charged failure to sufficiently investigate and evaluate significant unexpected

b. Special sales allowances

It is undisputed that Koeppel depended in part on the audit testing of Koss's so-called special sales allowances to assess the valuation of Koss's net sales. *See* pp. 11-12, 57 above. It is also undisputed that these sales allowances materially reduced the sales reported on Koss's income statement and materially contributed to the liabilities reported on Koss's balance sheet for fiscal years 2006, 2007, and 2008. Audit work on Koss's special sales allowances was therefore necessary to address the risk of material misstatement of Koss's financial statements for each of those years, including the risk,

differences between recorded amounts and the auditor's expectations, in violation of AU § 329.21, or to document such efforts under AS No. 3, ¶¶ 5-6. *E.g.*, OIP 13 ¶¶ 41-42. As to those charges, the initial decision found that the Division had proven only certain audit documentation failings. Specifically, the decision determined that in instances "in which the analytical procedures work papers indicate that a current-year amount differed from the [expectation of the] corresponding prior-year amount by more than the tolerable error amount established for the audit," the documentation of the "assessments that led [the auditors] to conclude that some amounts that exceeded tolerable error did not require evaluation as significant unexpected differences" was lacking under AU § 329.22. I.D. 63-64. But the hearing officer was prepared to accept, based on testimony of the 2006-2008 Staff/In-Charge Auditor, that "tolerable error was used only as a starting point in determining whether a difference was both significant and unexpected, requiring further evaluation in accordance with AU 329.21," and that, in any instance in which the auditors expected current-year amounts to remain unchanged from the prior year but encountered "differences that they concluded were both significant and unexpected," they "evaluated [such] differences," even if this was not documented. I.D. 64. And further on AU § 329.21, the decision, citing various work papers, found that the Division had not proven that there was a failure to "properly corroborate management explanations for unexpected differences." I.D. 64-66.

The Division's petition for review did not address the initial decision's resolution of these audit documentation issues under AU § 329.22, which applies "[w]hen an analytical procedure is used as the principal substantive test of a significant financial statement assertion," instead of under AS No. 3, which is not limited to a "principal substantive test." Nor, as Koeppel correctly notes (KRB 11 n.4), did the Division's petition address the initial decision's dismissal of the AU § 329.21 charges, partly on the basis of undocumented audit procedures asserted in hearing testimony. Rather, the petition cryptically claimed, "As Koeppel did not assert at the Hearing that additional undocumented audit procedures were performed during the Koss Audits, the A.S. No. 3 charges are not at issue." DPet. 2 n.3. Having otherwise found it unnecessary to decide whether the analytical procedures were the principal substantive test of net sales, and the Division having abandoned the AS No. 3 charges, we set aside, without considering, the hearing officer's findings of audit documentation deficiencies.

acknowledged by Koeppel, of material misstatement due to fraud relating to revenue recognition. For example, understatement of the allowances would overstate Koss's revenue and understate its liabilities. The auditor's objective is to obtain sufficient competent evidential matter to provide a reasonable basis for forming an opinion regarding the financial statements under audit (AU §§ 150, 326), and where, as here, the auditor performs only substantive tests, using information provided by the entity's information system, and does not test internal controls, "the auditor should obtain evidence about the accuracy and completeness of the information" (AU § 319.65).

Those tasks were made more difficult in the Koss audits by the lack of formal contracts or agreements in place that documented the terms of Koss's sales allowance program. Koeppel identified this in 2006 and 2007 as a control deficiency, which she believed did not allow the company, in the normal course of its functions, to prevent or detect misstatements on a timely basis, and in 2008 as a significant control deficiency, which she believed created a potential for a misstatement of Koss's financial statements that could be material. *See, e.g.*, Tr. 1121-27; Exs. J-39 at 2, J-132 at 2, J-239 at 7, 9. She "highlight[ed]" that this deficiency, as to a "judgmental accrual when we could not tie to third-party support or a contract," was "an area of concern and potential risk in [Koss's] financial reporting process." Tr. 1401-03. Referring to "the severity of this issue," audit work papers reviewed by Koeppel stressed "the limited amount of information provided to us (i.e. no support for percentage or fixed allowances" other than management's representation—that, as Koeppel described it, "this was a complete and accurate and reasonable accrual at the end of the period" (Tr. 1403)—"to determine reasonableness and adequacy of the accrual." Ex. J-226 at 1, 3; Ex. J-227 at 1, 4. The auditors also noted VP-Finance's claim that "most customers in [Koss's sales allowance] program are long-time customers which have proven reliable in the past, therefore [there is] no risk" (Ex. R-393 at 2; *see* Ex. R-295 at 2) and reasoned that Koss "has had the sales allowance program in place for a number of years with the same customers who participate, year over year" so "management is very knowledgeable of the allowances given and would likely be able to detect a material misstatement in the financial statements" (Ex. R-482 at 723). But that did not alter Koeppel's recommendation that Koss enter into signed agreements with its customers in the sales allowance program "so that these discounts are stated and accrued for correctly" (Exs. J-39 at 4, J-132 at 3) or Koeppel's findings that Koss did "not have proper documentation to support the discounts given and the related accrual" (Ex. J-239 at 7) and, at most, suggested that management might be in a position to record correct figures for the special sales allowances, not that it was actually doing so.[44/]

[44/] Contrary to rhetoric in Koeppel's briefing (KPHS 43, 89), Koeppel is not being "faulted for having properly identified the lack of written contracts" as a deficiency or significant deficiency in Koss's controls but rather for not effectively addressing the implications of the lack of written contracts for the audit work that needed to be performed on Koss's special sales allowances under PCAOB auditing standards.

Under such circumstances, the importance was apparent of the auditor being "thorough in his or her search for evidential matter and unbiased in its evaluation" (AU § 326.25). PCAOB auditing standards make clear that the difficulty and expense that may be involved in testing a particular item "is not in itself a valid basis for omitting the test" (AU § 326.24); that management representations "are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit" (AU § 333.02); and that "[i]f the auditor is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though management has given representations concerning the matter, there is a limitation on the scope of the audit, and the auditor should qualify his or her opinion or disclaim an opinion" (AU § 333.14). Yet, as Koeppel knew, despite the clear need to test whether Koss's recorded fiscal year-end balances included all of the customers entitled to special sales allowances and all of the amounts to which they were entitled, the audit work attended to what Koss recorded while doing little, if anything, to test whether items that should have been recorded were, in fact, recorded.

As discussed in detail above (pp. 57-63), the special sales allowance work central to the parties' arguments about each audit consisted of the following. First, audit procedures were performed using a Koss report that purported to show customer balances of special sales allowances at the end of the prior fiscal year, the customers' monthly special sales allowance activity in the current fiscal year, and the customers' allowance balances at the end of the current fiscal year. Namely, the auditors performed "some clerical tests" (Tr. 1404) on the mathematical accuracy of that allowance schedule; reconciled the total June 30 balance outstanding on that schedule with a June 30 Koss trial balance report; recomputed two months of four customers' percentage-based allowances shown on the allowance schedule using a Koss sales report and comparing those percentages to the allowance schedule from the prior fiscal year, which, under Koeppel's approach to the Koss audits, had similarly been tied to a June 30 Koss trial balance; tied one customer's fixed allowance shown on the schedule to a written contract in the 2006 audit and to a credit memo in the 2008 audit; and tied four to ten allowance claims shown on the allowance schedule, each from a different customer, to credit memos in each audit.

Second, the auditors "reviewed" a Koss list of credit memos issued in the fourth quarter of the current fiscal year. In the 2006 and 2007 audits, that procedure consisted of comparing the total balance of the items on the list to the balance of unsettled special sales allowances at June 30 on a Koss trial balance report and tracing ten to twelve items on the list to underlying credit memos. In the 2008 audit, the procedure consisted of scanning the list for large or unusual credits along with asking VP-Finance whether there were write-offs or significant credit memos issued after June 30.

Third, the auditors "reviewed" a Koss list of credit memos issued subsequent to the end of the fiscal year under audit but before issuance of Koss's financial statements. This meant scanning the list for significant or unusual items and additionally in 2006 comparing a $5,900 special sales allowance item and a $9,963.14 other item on that list to an underlying credit memo for each item. Additionally, in each of the three audits, the auditors compared the total balance of unsettled special sales allowances at June 30 of the current and prior fiscal year, as shown on a Koss trial balance report.[45/]

No other audit procedures than those summarized above were applied to the Koss reports used in the substantive testing of Koss's special sales allowances. For example, due to the lack of audit work on the reliability of the Koss monthly sales reports used by the auditors to recompute, for certain customers for certain months, the special sales allowances shown on Koss's allowance schedule, that procedure provided little, if any, evidence about the schedule's reliability. Koeppel's own briefing describes the "[s]ubsequent reviews of credit memos" as going to "the accuracy of the Allowance Schedules and the accrual," not to completeness. KPHS 90. Tying the balance of a Koss IT system-generated detail report used in the special sales allowance testing to a Koss trial balance did not address whether items might have been omitted from both reports, even apart from other limitations to which that procedure was subject here, as discussed in depth in the next section. *See, e.g.*, Tr. 1404 (discussing tie-out of total balance on Koss's allowance schedule to a Koss trial balance and "perform[ing] some clerical tests" on the schedule as providing "a reasonable basis to determine that the [schedule] was accurate," with no mention of completeness).

We find that Koeppel, in relying on this audit work, known to her, on Koss's special sales allowances to form her audit conclusions and authorize issuance of the unqualified opinions on Koss's 2006, 2007, and 2008 financial statements, without having directed that necessary further audit work be done, violated AU §§ 150, 326, and 319.65 by not performing the necessary further audit work herself.

[45/] There is no indication in the record that the 2006 or 2007 so-called field work or post-field-work credit memo reviews, or the 2006, 2007, or 2008 audits more generally, identified what the Division's expert described, based on the Koss-prepared sales allowance schedules in the work papers, as "a pattern of exceptionally high credit memos during the two months after" June 30 of 2005, 2006, and 2007. *See* Ex. D-2 at 62, 67-68, 116 ($437,158 in discount and rebate claims in August 2005 alone, nearly $300,000 more than next highest month, out of $1,406,916 total for fiscal year 2006; $662,587 in such claims in August 2006, over $550,000 more than next highest month, out of $1,086,548 for the year; $670,773 in such claims in July 2007, nearly $400,000 more than next highest month, out of $1,703,489 million for that fiscal year); Exs. J-42, J-135, J-228 (Koss sales allowance schedules for fiscal years 2006, 2007, 2008).

c. Accounts receivable

There are several aspects to the charges against Koeppel in the accounts receivable area. First, with respect to the accounts receivable testing as of the April 30 interim date in each audit in question, the Division argues that Koeppel relied on a Koss IT system-generated report as the basis for selecting the sample of receivables to be used for the confirmation testing without sufficient audit evidence of the completeness of that report. Second, the Division argues that Koeppel relied on May-June remaining period testing in each audit that, as a result of the confirmation testing not being adequately grounded in Koss's accounting records, was not tied to the interim period testing and so did not cover the remaining period in a way that provided a reasonable basis for extending to the balance sheet date the audit conclusions from the tests of details at the interim date. Third, the Division argues that Koeppel relied on a so-called rollforward procedure in the 2006 and 2007 audits to cover the remaining period that was also inadequate because it consisted of comparing subledger and trial balance reports generated by Koss's IT system with each other, without sufficient evidence of the completeness of those reports. Fourth, the Division argues that Koeppel relied in the 2008 audit on audit work that made no reference to the performance of any rollforward and that alternative procedures she has cited were inadequate to cover the remaining period. We find that Koeppel, in relying on the challenged interim testing in 2006-2008 and remaining period testing in 2006 and 2007 to form her audit conclusions and authorize issuance of the unqualified opinions, without directing her audit assistants to perform necessary further audit work, violated AU §§ 150, 230, and 326 and AU §§ 313.08 and 319.65, respectively, by not herself performing the necessary further work.

Confirmation of accounts receivable is typically an important audit test. *See, e.g., S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 WL 3339647, *14, *22 (July 3, 2013). Subject to certain exceptions not relevant here, "there is a presumption that the auditor will request the confirmation of accounts receivable during an audit." AU § 330.34. There is no dispute that the confirmation testing was the principal substantive test of accounts receivable in the 2006, 2007, and 2008 Koss audits and no claim that the other substantive tests of details or the analytical procedures were sufficient to reduce audit risk to an acceptably low level for the applicable assertions. *See* Tr. 1353, 1357 (Koeppel); KOB 44; *see also, e.g.*, Tr. 887-89, 893, 919, 937 (Koeppel testified she understood that AU § 313 applied to the accounts receivable audit testing, which used confirmation procedures at interim); AU § 313 (standard addresses "applying principal substantive tests to the details of balance-sheet accounts at interim dates").

In each audit, Koeppel knew that confirmation testing was performed on Koss's accounts receivable at the interim date of April 30 and she treated an April 30 AR Aging Report generated by Koss's IT system and provided by its accounting department as capturing the entire population of its accounts receivable at April 30 for purposes of selecting a sample of receivables for the confirmation testing. There is no dispute that either these reports should have been reconciled to Koss's general ledger, which admittedly was not done in any of the three audits, or other audit evidence should have been obtained as to the reports' completeness and accuracy. *See, e.g.*, I.D. 45, 47, 50; Tr. 908-09, 1361 (Koeppel); Tr. 445-46 (2007-2008 Staff/In-Charge Auditor).

The auditor's substantive procedures "must include reconciling the financial statements to the accounting records" (AU § 326.19), and substantive tests designed to cover the period between the interim date and the balance sheet date "ordinarily should include [] comparison of information at the balance-sheet date with the comparable information at the interim date to identify amounts that appear unusual and investigation of any such amounts" (AU § 313.08(a)). Use of reports for interim date audit testing that do not reflect the company's actual financial condition at that time would defeat those requirements by allowing an undetected, untested gap to exist between the interim date audit testing and the company's true interim date financial information, the remaining period audit testing that is premised on the interim audit work, and the financial statements. Moreover, completeness of the reports was critical to the efficacy of the confirmation testing. This is because that testing depended on audit sampling of an overall accounts receivable population and "[s]ample items should be selected in such a way that the sample can be expected to be representative of the population," which means "all items in the population should have an opportunity to be selected" (AU § 350.24). *See, e.g.*, Tr. 881-83 (Koeppel); Tr. 885 (agreeing that Grant Thornton's audit methodology at the time reasonably provided that, as an item erroneously excluded from a population to be sampled cannot be selected for testing, supplementary procedures should be performed to support that the sample population is complete); Exs. J-60 at 160, J-139 at 269, J-269 at 273 (2006-2008 firm manuals, stating that an example of such a procedure would be "footing the population and agreeing it to the general ledger"); Tr. 403 (2006-2008 Staff/In-Charge Auditor: acknowledging that receiving confirmations back from customers does not necessarily indicate that all items that should have appeared on the AR Aging Report were there). As a Grant Thornton training program Koeppel attended in January 2007 stressed, "Don't waste time on an incomplete file! Would you select A/R confirmations sample or Inventory price test sample items before you tied out your detail to the ending balance? No, you wouldn't." Ex. J-130 at 20; *see* Tr. 796-802 (Koeppel); Ex. J-306 at 1.

Although Koeppel does not dispute that in the audits in question the interim date AR Aging Reports used for the accounts receivable confirmation testing were not tied to any other Koss reports, she appears to claim that she could reasonably have thought each was, in fact, reconciled to a trial balance report. *See* Tr. 1361 (stating she did not believe she was aware at the time of the audits of the lack of a reconciliation). Koeppel does not specify the grounds for her supposed belief, and, based on a thorough review of the record, we find that the preponderance of the evidence is to the contrary of her claim to have had a reasonable basis for that belief.

In this regard, Koeppel has described herself as a "highly engaged" and "thoroughly engaged" auditor, an "active participant in the audits." KPHS 2, 5-6. The other Koss audit team members who appeared at the hearing described Koeppel as “very involved” and “actively involved” in the audits (Tr. 181, 184-85), a “very, very hands-on partner” (Tr. 530) and an “extremely detailed” and “very thorough” reviewer of the audit work (Tr. 531, 686). Koeppel testified that confirmation of accounts receivable was “an area I would focus on” in the audits. Tr. 1353. Indeed, she contends that the confirmation procedure was the primary audit test used to obtain evidential matter about not only Koss’s accounts receivable but its revenue generally, which, in her view, was one of the two “critical transaction cycles” in the audits and subject to a potential fraud risk, as well as the potential risks of management override of internal controls and lack of segregation of duties. *See, e.g.*, Tr. 830-32, 872-74, 1021, 1353, 1356, 1387; Exs. J-3 at 1, 3, J-100 at 3, 4, 6, J-200 at 3, 4, 7; Tr. 779; KOB 44; KPHS 72.

Considered in this context, Koeppel knew that in each audit certain items were excluded from Koss’s April 30 AR Aging Report for purposes of confirmation testing and that in 2007 and 2008 that report was modified before a sample was even selected for confirmation. At the hearing, an audit team member who was involved in that work cited the modifications as a complicating factor that was partly responsible for the lack of any attempt to perform an interim-date reconciliation. Tr. 446 (2007-2008 Staff/In-Charge Auditor). Koeppel further knew that there could be a large difference, and swing in the relationship, between the total population of April 30 receivables used for confirmation testing and the April 30 trial balance used as the starting point for the rollforward. *See* Exs. J-30 at 1, 6 & J-31 at 1, 5 (former exceeded latter by $1,486,784 in 2006), Exs. J-123 at 2, 12 & J-125 at 1, 10 (former fell short of latter by $13,415 in 2007). And, in the audits, she was aware of large swings between the size of the receivables population at April 30 of the current year used for confirmation testing, on the one hand, and Koss’s accounts receivable balance at June 30 of the prior fiscal year and/or the trial balance at June 30 of the current fiscal year, just two months after the interim testing date, on the other hand: $9,290,117 compared to $9,227,938 and $7,750,762; $6,821,607 compared to $7,750,762 and $8,749,662; and $4,693,212 compared to $8,749,662 and approximately $11,000,000, respectively. *See* Ex. J-20 at 1, 4; Ex. J-30 at 1, 6; Ex. J-114 at 1, 7; Ex. J-123 at 2, 12; Ex. J-220 at 1, 48; Ex. J-268 at 26. All of this would have drawn attention to an interim reconciliation, if one had been done.

Moreover, Koeppel testified that Grant Thornton’s proprietary software used in the Koss audits to generate audit programs with firm-suggested procedures did not include an audit work step for reconciling accounts receivable subledger reports to the general ledger as of an interim date but only as of fiscal year end, that she did not tailor the Koss audit programs to include such a step, and that she would have been aware, through approval of the program, if any audit assistant had done so. Tr. 1362, 1437; *see* Exs. J-16 at 1, J-110 at 3, J-210 at 2 (work step in revenue audit program, under heading “Year End” and/or to which fiscal year-end reconciliation attached: “Test the footings of subsidiary ledgers (accounts, notes and installments receivable) and agree the total with the general ledger control.”). Indeed, as she recognized, and as the firm’s audit manuals state, the “‘B’ approach” of those audit programs was not specific to a low-inherent-risk-high-control-risk audit, in which internal controls might not be tested and other methods might need to be used to determine the reliability of system-generated reports, but also applied to a high-inherent-risk-low-control-risk-audit, in which, to assess control risk at low, controls would necessarily be tested and so other means might not be needed to determine the reliability of the reports. Tr. 1439-44.

At the hearing, Koeppel seemed to state it was her view during the audits that reconciliation of Koss's AR Aging Report only at fiscal year end was sufficient, under the firm's methodology, as applied by her in those audits: "our methodology addresses the need to test reports for completeness and accuracy, that that's embedded in the tests that we do and the fact that you…tied reports back to the general ledger or the trial balance, that you footed them. Those are all tests of completeness that are embedded into our methodology. And we talked about that in training, we talked about that the steps were designed to incorporate those into our work, and so that I didn't feel it was necessary, on this engagement or any other engagement, to tailor in a whole bunch of more steps" to address the reliability of Koss's reports. Tr. 1498. Koeppel takes that very position in this litigation: "most importantly, the same management-prepared report from which accounts receivables were selected at interim for confirmation (the AR Aging Report) was tied each year without exception to the general ledger [trial balance report] at year-end…[t]he fact that the same report as of year-end reconciled without exception to the general ledger provided the auditors with evidence of the completeness and accuracy of the AR Aging Reports used at interim." KPHS 37-38. This position aligns with the testimony of another Koss audit team member, expressed as reflecting a collective view, that "we didn't feel it was necessary" to do an interim reconciliation. Tr. 435, 445-46, 524-25 (2007-2008 Staff/In-Charge Auditor).

Consistent with the foregoing, in selecting work papers to review, Koeppel made a point of reviewing in the 2006 and 2007 audits a work paper titled "AR Reconciliation" and in the 2008 audit at least a notation on the audit program attaching an "AR Lead and Reconciliation" work paper. Exs. J-32 at 1, 5, J-126 at 1, 7, J-221 at 5. Containing no reference to any interim-date reconciliation, those work papers tied Koss's fiscal year-end AR Aging Report to a Koss fiscal year-end trial balance report. There was a difference between the June 30 "Balance per Aging" and the June 30 "Balance per G/L" (balance per trial balance report) of $964,975.55, $1,232,560.35, and $701,679.97, in 2006, 2007, and 2008, respectively, involving additions and subtractions that, in absolute amount, totaled $1,087,356.01, 1,278,181.13, and $934,767.81, respectively. *Id.* (identifying reconciling items of "I/C Balances" ("intercompany AR" among Koss related entities), "Cash in transit," "Reclass of AR credit balance" ("GT recomputed the credit balances per the AR aging"), and "Reclass of Office Depot Rec." ("not truly a receivable until the consigned inventory is sold…Office Depot sends Koss a monthly report showing what sold so Koss knows what to recognize as revenue")).

Additionally, Koeppel specifically signed off on work papers that identified the balance of the April 30 accounts receivable population used for the confirmation testing but that marked that balance only with a tick mark stating that it had been tied to Koss's April 30 AR Aging Report. Exs. J-30 at 4-5, 6 (2006), J-123 at 2, 10-12 (2007), J-220 at 1, 47, 48 (2008). The standard "beta" tick mark used in the Koss audits to signify that a balance had been tied to a trial balance report (*see e.g.*, Tr. 1457-58 (Koeppel)) was absent, the work paper contained no such reconciliation, and no other procedures were documented to determine the reliability of the April 30 AR Aging Report. If any audit work on a interim-date reconciliation had been performed for 2008, that work paper (Ex. J-220) would have been the place to find it, according to the notation Koeppel reviewed on the 2008 audit program. *See* Ex. J-221 at 5.

Koeppel also reviewed the work paper for the procedure performed in the 2006 and 2007 audits to "roll forward" the interim accounts receivable balance to the balance sheet date. The work paper showed that the starting point for that procedure was the "Balance Per 4/30/[2006 or 2007] G/L," a trial balance. But the work paper contained no reconciliation to the April 30 AR Aging Report, whereas it specifically cross-referenced the tie-out of the June 30 trial balance, the end point of the procedure, to the June 30 AR Aging Report. *See* Exs. J-31 at 1, 5, J-125 at 1, 10. Koeppel could not have come across any interim date reconciliation elsewhere in the work papers, as none existed.

Incidentally, even if Koeppel had believed that an interim-date reconciliation was performed as part of the accounts receivable audit work, the most she claims would have been done would have been to tie Koss's April 30 AR Aging Report to a Koss April 30 trial balance report, as was done with the fiscal year-end reports. *See, e.g.*, KPHS 37-38 & n.18, 83, 84 n.24. Yet, as she knew, neither Koss's IT system nor the operating effectiveness of Koss's internal controls was tested in the audits. She thus lacked the information that such testing could have provided about the extent to which Koss's information system may have been susceptible to errors or oversights in the entry of data into the general ledger and whether the system contained defects that could cause or enable it to wrongly capture, summarize, or report general ledger data.[46/]

[46/] *See, e.g.,* Ex. J-30 at 2 (2006 confirmation work paper reviewed by Koeppel: "GT had selected a deduction on the customer's account that was paid back, however, it was misapplied to the wrong invoice. As such the amount remained on the customer's account until the proper research was performed."); Ex. J-123 at 2-6 (2007 confirmation work paper, reviewed by Koeppel, identified two cases in which "payment [of invoice] was received into Koss's bank account" before April 30 but, per discussion with Senior Accountant, "A/R wasn't reduced" ("via entry to a Cash-in-transit Account which offsets [the general] A/R Acct"), and cash was not increased, until after April 30, when "a manual journal entry was made" to that effect); Ex. J-127 at 2, 5, 10 (2007 inventory rollforward work paper, reviewed by Koeppel: "[Per discussion with VP of Finance], [an] account was mistakenly omitted from the total [June 2007 inventory balance]" and also "GT notes [a] discrepancy" between May 2007 scrap balance in rollforward and in Koss scrap report, as to both of which the auditors did no further work because the amounts were below tolerable error); Ex. J-49 at 1 (Koss data entry staff "enters the [inventory]

Koeppel also knew that Koss's trial balance reports were printed at a particular point in time. And she knew, among other things, that they could not be reprinted as of that date at a later time for comparison purposes due to asserted IT system limitations; would not reflect the general ledger data for the relevant period if journal entries affecting that data were subsequently posted directly to the general ledger; and would not reflect the company's true financial condition at the time the report was generated if false journal entries had previously been posted directly to the general ledger, if false journal entries had previously been posted to a subledger and transferred to the general ledger, or if correct subledger data was excluded from system reports, as by system flaw or manipulation of the timing or content of the transfer of data from subledger to general ledger, none of which was effectively addressed in the audit work.

The Division is therefore correct that under these circumstances "[a]greeing the account balance on an information system-generated report to a balance appearing on the information system-generated trial balance does not provide evidence of the completeness or accuracy of the report (i.e., whether the auditor is auditing the right numbers), only that two system-generated reports reflect the same account balances. They could both be complete, be incomplete, or even reflect the same balances (through adjustments or otherwise), even though the transactions they each include are different." DPHS 70. Assertions at the hearing by Koss audit team members that they considered trial balance reports to be equivalent to the general ledger (*see* KPHS 24 n.10, 84 n.24) do not mean that, without more audit work, those reports could be treated that way in the audits in question. And citations by Koeppel to general propositions in "professional literature that a trial balance is essentially a snapshot of the balances of each account in the general ledger" (*id.*) only highlight the problem in those audits that the information in Koss's system-generated reports might have been altered through journal entries not necessarily provided to the auditors, even if those reports otherwise would have correctly captured, summarized, and presented the general ledger data.

receipt including order number, quantity and part number information into the system to update perpetual inventory once the goods have completed an initial inspection – note that this does not update the g/l. Once a week the accounting department reconciles differences b/w the g/l and inventory systems (usually clerical errors)….The VP of Finance reviews a listing of unmatched receipts on a monthly basis."); Ex. J-221 at 3 (2008 reconciliation of June 30 AR Aging Report to June 30 trial balance: "GT notes amount relates to a return that the Company was made aware of very close to YE, that did not get posted to the aging….As amount is below TE ($220,000) GT will PFW and accept as reasonable."); Ex. R-398 at 4 (VP-Operations "noted that on a weekly basis, she reviews the inventory file in the AS400 for such parts as those with no cost, negative costs, and negative qualities"). There is no evidence in the record of any consideration in the audits of possible systemic implications of any of these instances.

In particular, comparing the balance reflected on April 30 AR Aging Reports, after adjusting for certain reconciling items, to the accounts receivable balance reflected on April 30 trial balance reports would not identify, for example, certain omissions from the subledger detail reports used in the procedure that could contribute to an overstatement of Koss's trial balance. Specifically, the procedure would not identify the omission from those detail reports of certain genuine items that reduce the accounts receivable balance, combined with, in equal amount, the omission from those reports of false items that increase the balance and/or the direct inflation of the trial balance through posting false sales to the general ledger or including so-called "intercompany" sales between related Koss entities, which do not belong in Koss's financial statements. In that example, some items that would reduce the accounts receivable balance and would not be part of the sample selected in the audits for confirmation, such as credit memos and cash in transit (cash received but not yet applied to a particular receivable), could be omitted from subledger detail provided to the auditors. The resulting inflation of the balance derived from the AR Aging Report used in the audit testing could mask an inflation of the accounts receivable trial balance attributable to false sales omitted from the AR Aging Report or to a combination of such omissions, false sales posted directly to the general ledger, and miscategorized or disguised intercompany sales.[47/]

Despite the lack of a reconciliation of the April 30 AR Aging Report to the general ledger, Koeppel argues that "appropriate evidence of the completeness and accuracy of the Interim A/R Aging Reports" was obtained because (1) "[t]he same standard reports from which accounts receivable were selected at interim were tied without exception to the general ledger at year-end in each of the Relevant Audits" and (2) "[t]he year-end A/R Aging Reports were also subjected to a variety of tests of details that included tracing the items on the reports to source documents." KOB 49; *see* KRB 12 ("it was reasonable to place 'reliance on the system' that generated A/R Aging Reports by tying the year-end A/R Aging Reports to the general ledger and performing other procedures on those reports, including tracing individual items back to source documents").

The initial decision correctly rejected the first of these contentions: "Even assuming that the engagement teams could have utilized the year-end reconciliations—which they did not have when they selected receivables for confirmation from the Interim A/R Aging Reports—to draw conclusions about the completeness and accuracy of the Interim A/R Aging Reports, there is no evidence in the work papers, or testimony from any engagement team member, that they did so," and "the fact that a year-end report can be reconciled to the general ledger does not, by itself, establish that an

[47/] The alternative audit procedures used in the 2006, 2007, and 2008 audits when a selected receivable was not confirmed by the customer involved matching certain of those receivables to subsequent cash receipts and certain others to credit memos, but the work papers identify only some of those payments as having been received, and only a few of those credit memos as having been issued, during the confirmation period. *See* Exs. J-30 at 1-2, J-123 at 1-8, J-220 at 44-46, all reviewed by Koeppel.

interim report could also be so reconciled—the report might have been incomplete or inaccurate at the interim date, but corrected by year-end." I.D. 49 & n.22. Koeppel's argument also ignores the possibility that, through management override of controls, the interim report could have been manipulated so that it did not reflect the general ledger or the general ledger itself could have been manipulated through false journal entries. She understood that the auditors were limited in their ability to test Koss's journal entries for fraud by their preferred method, knew that they instead depended on what Koss's small accounting department represented were binders of paper copies of journal entries posted and compiled by that same department, was specifically put on notice by the 2005 PCAOB inspection, as well as Grant Thornton training, about the issue of completeness of the population of journal entries selected for testing, and, as we have found, violated PCAOB auditing standards regarding that testing. Additionally, she knew the limited nature of the rollforward testing, discussed below, which was meant to extend the conclusions formed at the interim date to the balance sheet date.

Similarly, Koeppel's second contention cites tests of details to which "the year-end A/R Aging Reports" were subjected, not any procedures applied to the interim AR Aging Reports. The audit tests she does cite are shipping cut-off testing in 2006, 2007, and 2008 and an assessment in 2006 and 2008 of whether receivables were being properly aged. KOB 49; KPHS 38 n.19. But the six invoices each year subject to that cut-off testing represented what audit team members acknowledge was a very small or miniscule amount of the receivables on Koss's AR Aging Report at any given time, limited to those immediately before and after the end of the period, and the 10 or so invoices selected from the June 30 AR Aging Report for the audit work on aging in 2006 and in 2008 represented only 1.6% and 1% of the respective year's report balance. *See* pp. 65-66 above. Not only did the small scale of this testing limit any support it provided for the reliability of Koss reports, but also the nature of the testing led Koeppel and other audit team members themselves to describe it as "supporting the reports' accuracy" rather than completeness. *See* KPHS 38 n.19; Tr. 401-03, 713-14.

We therefore conclude that in the 2006, 2007, and 2008 audits, Koss's April 30 AR Aging Report was not reconciled to Koss's general ledger, sufficient evidence of the completeness of the report was not obtained by other means, and Koeppel knew the facts necessary to these conclusions. Consequently, the interim date audit testing was not adequately grounded in Koss's accounting records, sufficient competent evidential matter was not obtained to support the existence of Koss's accounts receivable, in violation of AU §§ 150, 230, and 326, and the interim date testing was not linked to the rollforward procedures performed in the 2006 and 2007 audits, making it impossible for the rollforwards to supply a reasonable basis for extending to the balance sheet date the audit conclusions from the interim work, in violation of AU § 313.08. Further, even if the accounts receivable balance used for the interim testing had been reconciled to the accounts receivable balance used to commence the rollforward, the remaining period testing was independently deficient, as discussed next.

Where, as here, the auditor performs only substantive tests, using information provided by the entity's information system, and does not test internal controls, "the auditor should obtain evidence about the accuracy and completeness of the information." AU § 319.65. Applying principal substantive tests to the details of an asset or liability account, such as accounts receivable, at an interim date rather than the balance sheet date potentially increases the risk that the auditor will not detect misstatements that might exist at the latter date. *See* AU § 313.03. Under PCAOB auditing standards, substantive tests need to be designed to control that potential increased audit risk and should cover the remaining period in such a way that the assurance from those tests and the substantive tests applied to the details of the balance as of an interim date, and any audit assurance provided from the assessed level of control risk, achieve the audit objectives at the balance sheet date. AU §§ 313.03, .08. In the audit work on the existence of Koss's accounts receivable, control risk was assessed at the maximum, and only substantive tests were performed, so audit assurance was not provided from the assessed level of control risk.

In the 2006 and 2007 Koss audits, the only audit procedure identified as designed to cover the remaining period was the so-called rollforward. *See, e.g.*, Ex. J-125 at 3; KPHS 38, 84. The procedure played an important role. *See, e.g.*, Ex. D-4 at 90-92 (Audit Manager's investigative testimony). A notation on the revenue audit program for the 2006 Koss audit attached the work paper for the rollforward and indicated that it was an alternative audit procedure for fiscal year receivable accounts not confirmed, and the rollforward work paper concluded, "Per the testing of the AR roll forward, AR appears to be properly stated as of year-end." Ex. J-16 at 3; J-31 at 2. The revenue audit program for the 2007 Koss audit specifically referred to "the roll forward period," bore a notation referring to "review of the roll forward activity," and included as an attachment the rollforward work paper, which explained, "As A/R was confirmed as of 4/30/07, GT will test activity between the confirmation date and year-end to further validate the year-end A/R balance." Ex. J-110 at 3-4; Ex. J-125 at 3, 6.

The rollforward took Koss's April 30 receivable "Balance per GL," which in the Koss audits meant a trial balance, added to it Koss's May and June sales and credit balances and subtracted from it Koss's May and June cash receipts and Koss's inventory still on consignment at a retailer at the end of June ("Office Depot Reclass"), made a further modification of the receivable balance for May and June cash in transit, and then compared the resulting receivable balance with a Koss June 30 trial balance report. *See* pp. 66-69 above. Thus, the beginning and ending accounts receivable balances used in the rollforward were trial balances, and the May and June activity data came from subledger detail reports, mainly Koss's monthly AR Distribution Register, all generated by Koss's IT system and provided by its accounting department.

In Koeppel's view, "[t]he successful performance of the rollforward procedures themselves demonstrated the accuracy of the data used in them" and "serve[d] as evidence that the reports used in the rollforwards were accurate and complete." KPHS

39, 84. She reasons, "If an entry had been posted to the general ledger and omitted from the subledger A/R Distribution Register, the rollforward procedure would not have been able to reconcile the interim general ledger balance with the closing general ledger balance." *Id.* The initial decision agreed (I.D. 53), simply declaring it is "the net number that is being tested at year-end" and "as a practical matter the fact that the roll forward reconciles provides additional evidence as to the accuracy of the individual categories" of transactional data summed in the procedure. But Koeppel's argument assumes from the mere mathematical agreement of balances or sums of balances of various reports that the transactions listed or purportedly reflected in the reports were valid or recorded correctly and that all of the transactions that occurred were recorded and reflected.

For one thing, Koeppel's argument depends on Koss IT system-generated reports for the "general ledger balance." After the reports used in the rollforward were generated, however, a journal entry affecting the accounts receivable balance for the relevant period could be posted directly to the general ledger, either as an initial matter or to reverse parts of a previously posted revenue-neutral journal entry involving multiple accounts or categories of items in one account, all in the absence of proper testing of journal entries in the Koss audits.

Koeppel did observe in testimony that "[t]ypically, [a trial balance report, generated from the general ledger] is the document that is then tied to the consolidating workbook [*i.e.*, another general ledger report]," which "is what supports the Ks and Qs the company files" (Tr. 1457), suggesting an unbroken chain in each audit of tying a trial balance report to a general ledger report more closely resembling the financial statements and finally to the financial statements themselves. But this does not address the risk of error or oversight in the entry of data into the general ledger over the relevant period or of a systemic flaw affecting all of the reports' depiction of the general ledger data. Nor does it address whether the transfer of data from Koss subledgers to its general ledger could be manipulated in relation to the generation of the general ledger reports or items could be omitted from the subledger detail reports used to "roll forward" the interim trial balances to June 30, quite apart from the possibility that detail reports could contain false items that escaped detection by the ordinary audit tests. If, for example, false sales (and related receivables) posted directly to the general ledger and a corresponding amount of true items that reduce accounts receivable were both omitted from subledger reports, those reports would agree to a general ledger accounts receivable trial balance that was a composite of the false sales and all other items, additive and subtractive, contributing to that overall account balance.[48/]

[48/] The reconciliation in each audit of the June 30 AR Aging Report to the June 30 accounts receivable trial balance was susceptible to the same potential problems. Moreover, misstatement due to error or fraud is even less likely to be detected by a reconciliation procedure if the auditor does not check that the balance totals listed on the detail report correctly reflect the line items on that report. According to a notation reviewed by Koeppel under a work step on the revenue audit program for the 2008

Koeppel's emphasis on tying IT system-generated general ledger reports and subledger detail reports to one another and to each other obscures that this does not constitute direct, detail testing of any report entry or reconciling item. Without sufficient support for the reliability of that data, the reconciliation becomes an all but meaningless exercise. To illustrate, tying out one general ledger report to another can involve large reconciling items. *See, e.g.*, Ex. R-277 at 2 (tie-out to a consolidating workbook). The offsetting, reconciling items flowing through the accounts receivable rollforward purportedly totaled May-June sales of $8,294,738.81 in 2006 and $8,524,441 in 2007; May-June cash receipts of $8,869,117.88 in 2006 and $6,534,796 in 2007; May-June gross cash in transit of $776,339.99 in 2006 and $412,361 in 2007; May-June credit balances of $61,190 in 2006 and $22,810 in 2007; and $240,530.08 in inventory on consignment at a retailer as of June 30 in 2006 and $57,029 in 2007. In 2006, no audit procedures were applied to the subledger detail reports that were the source of these items to determine their reliability. In the 2007 audit, ten cash receipts each from May and June, totaling $180,498.93, were traced to underlying documents and to the respective month's AR Distribution Register; ten invoices each from May and June, totaling $255,278.65, were traced to underlying documents and to Koss daily subledger reports called Invoice Summary Registers; and those reports' daily total invoice balances were traced to the AR Distribution Registers. But none of this small-scale tracing of items from system-generated reports provided by Koss's accounting department addressed items that might have been omitted. This created an important opening for misstatement due to error or fraud in a major area of the audit.

There is no indication in the record that the accounts receivable rollforward was performed in the 2008 Koss audit, and Koeppel concedes that it was not performed. Tr. 1365; *see* Tr. 446-47 (2007-2008 Staff/In-Charge Auditor). The auditors have provided no explanation for the absence of the procedure that year, in light of its use in 2006 and 2007 and the use in 2006, 2007, and 2008 of a rollforward in another major audit area that was principally tested at April 30, inventory. Koeppel testified that "inherent" in her approach in the Koss audits was that "doing a roll forward" was part of what "gave us comfort that the system was working appropriately" and that Koss reports were reliable. Tr. 1092, 1186-88. And the work papers for 2008 do not denominate any other audit procedure or set of procedures as a substitute for the accounts receivable rollforward. Koeppel testified that she did not believe she had communicated to any member of the

audit, "As the 6/30/08 AR Aging is in paper format, GT footed and extended select customers w/o/e"—not all customers' items listed on the report. Ex. J-210 at 2; Ex J-221 at 5. In 2007, the corresponding notation and the cross-referenced work paper, both reviewed by Koeppel, did not state one way or the other whether the auditors tested the footings of the AR Aging Report, as called for by the work step. Ex. J-110 at 3; Ex. J-126. For 2006, the corresponding notation asserted, "GT footed the AR aging and notes that the aging footed correctly," without elaboration or any mention of this in the cross-referenced work paper, which Koeppel reviewed. Ex. J-16 at 1; Ex. J-32.

Koss audit teams that too many procedures were performed in 2006 or 2007 on accounts receivable activity recorded in the remaining period. Tr. 894, 914. She further testified that "I can't say if I was aware or not" at the time of the 2008 audit that the rollforward was omitted, that "I don't recall," and that "I don't believe I was." Tr. 937-38, 1365. Either she knew the rollforward was not done in 2008 or she believed, given her assertedly active role in planning the audits, prior approval and review of the procedure, and consistent approach to the issue of the completeness of system-generated reports used for substantive testing, that, as far as that issue was concerned, the rollforward was performed in 2008 in the same manner as in 2006 and 2007. Either way, more audit work needed to be done, Koeppel did not direct that it be done, and she did not perform it herself, which could be a factual basis for finding she violated AU § 313.08.[49/]

[49/] Koeppel has claimed in briefing in this case that "it appears" that she "delegated responsibility for review of the year-end 2008 accounts receivable work to [Audit Manager]." KPHS 40, 85. The brief bases this claim on inference from two work papers (Ex. J-221 ("AR Lead and Reconciliation") and Ex. R-426 at 4-6 ("Reserve for Doubtful Accounts")) that bear only Audit Manager's initials in the "Reviewed By" column. As to the first, work papers in the record permit a comparison to the counterpart document in the 2006 and 2007 audits, which bore both Koeppel's and Audit Manager's initials in that column. *Compare* Ex. J-221 at 5 (2008) *with* Ex. J-32 at 5 (2006) and Ex. J-126 at 7 (2007). The brief also notes that "[b]y the time of the 2008 audit," Audit Manager "already had four years of experience auditing Koss's financial statements, and was being promoted to partner." KPHS 10. But the particular Koss audit work papers on which Koeppel signed off varied from year to year, not following any pattern of increased reliance on Audit Manager, even as to remaining period testing. *Compare, e.g.*, Ex. J-222 *with* Ex. J-33. Her review of work papers was not limited to those on which she signed off. *See, e.g.,* Tr. 752-53, 835-37, 1064-65, 1072-75, 1101, 1131-32. And even if she did "delegate portions" of the "supervision of the audit to other firm personnel" (AU § 311.02; *see* KOB 7, 32; KPHS 6, 9, 54), that would not mean that she lacked any understanding or expectation, coming out of the prior audits and planning of the 2008 audit, about use of an accounts receivable rollforward in 2008 or that she delegated all responsibility for review of the work on Koss's year-end 2008 accounts receivable, part of one of the two "significant transaction cycles with critical assertions" in the audit. For example, Koeppel reviewed the notation on the 2008 revenue audit program that made various representations in response to the work step "[t]est the footings of subsidiary ledgers (accounts…receivable) and agree to the general ledger control" and that cross-referenced the year-end accounts receivable reconciliation. *See* Ex. J-221 at 5. She included the work paper containing that reconciliation (Ex. J-221) on an exhibit she prepared for the litigation (Ex. R-510 at 3) that she described on her list of admitted exhibits as "Partial List of Workpapers Reviewed by Ms. Koeppel During the Audits" (R.D. 79). And only her initials appear as reviewer of a notation on the audit program documenting "GT['s] review[]" of "the 'Month to Date – Commissions' report" for "unusual or significant items" that "need further investigation" (Ex. J-219), a procedure she claims helped "provide[] a reasonable basis to extend the conclusions from the

Koeppel insists that no more work than was done was necessary in any of the three audits on Koss's remaining period accounts receivable to comply with AU §§ 319.65 or 313.08. She argues that in each audit—in 2006 and 2007 along with an accounts receivable rollforward and in 2008 as an alternative to it—a combination of "tests of details on accounts receivable and analytical procedures on receivables and sales," performed at fiscal year end, "provided a reasonable basis to extend the conclusions from the interim procedures to the remaining period and the year-end balance" and, together with the interim procedures, "was the basis for [her] professional judgment that reasonable assurance had been attained with respect to Koss's accounts receivable." KOB 50; KRB 13; KPHS 40-41, 85-86. In briefing, she identifies in this regard a set of from eight to ten procedures each year. The eight 2008 procedures she cites had all been performed in one or both of the prior audits when a rollforward was also done. *See* Ex. R-507 at 72 & n.320.

Overall, Koeppel cites five procedures as having been performed in each of the audits: (1) shipping cut-off testing (Exs. J-28, J-120, J-249); (2) a scan of a Koss IT system-generated subledger detail report for sales recorded in June (Exs. J-29, J-122, J-219); (3) a comparison of revenue totals for each of the three months of the fourth quarter with those figures from the prior fiscal year (Exs. J-18, J-115, J-213); (4) a calculation, and a comparison with the prior year, of five fiscal year-end "Short Term Liquidity Ratios," one of which ("Days Sales in Receivables") included accounts receivable (Exs. J-19, J-112, J-245); and (5) a calculation of various ratios of receivables to assets, net worth, and sales, as well as the ratio of sales allowances to sales, as of fiscal year end, and a comparison to those ratios from the prior year (Exs. J-20, J-113, J-212). Her other work paper citations may be categorized as follows: (6) a 2006 and 2007 procedure calculating, as of fiscal year end, the ratio of the reserve for doubtful accounts to accounts receivable, of bad debt expense to sales, and of average accounts receivable to daily sales (similar to the days sales in receivables calculation in the fourth procedure, except dividing accounts receivable by a calculation of gross sales, instead of net sales, divided by 365 days), and comparing these ratios to the prior fiscal year-end ratios (Exs. J-21, J-114); (7) a 2006 and 2008 procedure that tested the aging of ten or twelve items on Koss's June 30 AR Aging Report by comparing them to the underlying invoices (Exs. R-227, R-426 at 4-5); (8) a 2007 procedure that compared Koss net sales totals for each quarter of the current to the prior fiscal year (Ex. J-116); (9) a 2007 procedure that listed October, November, and December 2006 Koss sales by product line and compared them to those figures for 2005 (Ex. J-141); (10) a 2007 and 2008 fourth-quarter export sales territory work paper (Exs. J-146, J-231); and (11) the 2008 reconciliation of the AR Aging Report to a trial balance at June 30 (Ex. J-221).

interim procedures to the remaining period and the year-end balance" for Koss's accounts receivable (KOB 50; KRB 13; KPHS 41).

Although Koeppel, relying on her expert, asserts generically that such of these procedures as were performed in each audit “should be considered in their totality” or “cumulative effect” and that “viewing them in that light, they were sufficient” for purposes of her argument (KRB 13; KPHS 40, 41, 86), we agree with the hearing officer that the expert “failed to explain in any reasonable manner” how that was so (I.D. 54). The audit documentation does not indicate that any of these procedures to which Koeppel now points were “substantive tests to cover the remaining period” (AU § 313.03). None of them provided any tie to, or even cross-referenced, the interim period testing performed. Linking the cited procedures to the interim testing would be part of determining whether the procedures “provide a reasonable basis for extending to the balance sheet date the audit conclusions from the tests of details at the interim date” (*id.*). None included a “comparison of information concerning the balance at the balance-sheet date with the comparable information at the interim date to identify amounts that appear unusual and investigation of any such amounts” (AU § 313.08(a)). *See, e.g.*, Tr. 2036-51 (Koeppel’s expert conceded this as to all four of those procedures about which he was specifically cross-examined, Ex. J-212, Ex. J-213, Ex. J-221, Ex. R-426). A purported remaining period procedure that did not isolate data from the May-June period or limit any interim period data that was included in the procedure to data tied to and necessarily supported by the interim testing could include data that was inconsistent with the data tested at interim—for example, a June 30 balance could include interim period activity different from that provided for audit testing at interim—and thereby skew any conclusions about Koss’s remaining period activity that might be drawn from the procedure. And as in the audits more broadly, adequate audit work was not performed to determine the reliability of the Koss IT system-generated data used in the procedures. The cited procedures did not achieve compliance with AU §§ 313.08 or 319.65 in any of the Koss audits.

One procedure Koeppel cites (the second) involved only a scan of purported June sales on a Koss IT system-generated report to which no audit procedures were applied. This work did not involve any other procedures to test Koss’s June accounts receivable activity or any examination of the May activity.

Three of the cited procedures (numbers one, seven, and eleven) were applied to Koss’s June 30 AR Aging Report. As previously discussed, the first procedure, shipping cut-off testing, was limited to a small number and amount of transactions, immediately around period ends, and, as explained by a Koss audit team member, was performed to obtain evidence that sales were booked in the right period rather than to obtain evidence of the existence of accounts receivable. *See* pp. 65-66, 152 above; Tr. 710-12 (2007-2008 Staff Auditor) (citing Ex. J-120). The risk of incorrect items did not just exist at period ends. Indeed, the inspection comment form on the 2005 Koss audit had identified the issue of “[t]esting of journal entries throughout the period” (Ex. D-1 at 1), not just at a period end, and Koeppel has stated she took the comment “very seriously” (KOB 22, KPHS 69) and was mindful of it throughout the later Koss audits she led (Tr. 813-14, 1325). *See* R.D. 118 at 43 (oral argument); Ex. D-4 at 80-81 (Audit Manager’s investigative testimony).[50] The seventh procedure, which tested the aging of about a dozen items on a Koss June 30 AR Aging Report by tracing them to invoices the work papers do not indicate were confirmed with customers, provided very limited evidence of the existence of Koss's accounts receivable and was not focused on the remaining period. *See* pp. 66, 152 above. The eleventh procedure reconciled the total accounts receivable balance on a June 30 Koss AR Aging Report with that on a June 30 Koss trial balance report, which, as we just discussed, simply tied one Koss IT system-generated report to another at fiscal year end, without any effective link to the interim period testing or any focus on or particular testing of remaining period activity.

Koeppel's remaining seven citations are to analytical procedures, which she viewed as having even less weight, especially analytical procedures on sales, than tests of details in the work on accounts receivable in the Koss audits. *See, e.g.*, KPHS 72 ("substantive tests of details on balance sheet accounts" were "the principal source of evidence for all of Koss's revenue cycle accounts"); KPet. 8 ("accounts receivable testing served as the principal substantive test" to support "the valuation and occurrence of accounts receivable on the balance sheet"). Each analytical procedure relied for its expectations on Koss IT system-generated data from the prior fiscal year, when no more audit work had been performed than in the current fiscal year with respect to the reliability of such data. *See, e.g.,* p. 139 n.41 above. The "expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements" depends in part on "the availability and reliability of the data used to develop the expectation." AU § 329.11. And because management override of controls, which the flawed journal entry testing and the otherwise flawed substantive testing failed to properly address, could "allow[] adjustments outside of the normal period-end financial reporting process to have been made to the financial statements" that "might have resulted in artificial change to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions," "substantive analytical procedures alone are not well suited to detecting fraud." AU § 329.10.

Three of the analytical procedures cited by Koeppel (numbers four, five, and six) included accounts receivable in calculating one to several fiscal year-end ratios that are compared to the prior year ratios. Any evidence these procedures might have provided about remaining period accounts receivable activity was diluted by their lack of any

[50] *See generally, e.g.*, AU §§ 316.52 ("because an intentional misstatement," involving, for example, inappropriate revenue recognition, "may have been initiated in an interim period, the auditor might elect to apply substantive tests to transactions occurring earlier in or throughout the reporting period"), .58 ("[m]aterial misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process" by "recording inappropriate or unauthorized journal entires throughout the year or at period end"), .62 (material misstatements due to fraud "can occur throughout the period and may involve extensive efforts to conceal how it is accomplished").

effective link to the interim period testing, their use of fiscal year-end accounts receivable balances, their consideration of accounts receivable only as one factor in a ratio, and their failure to support the reliability of Koss system-generated data used in the procedures. The ninth procedure addressed the second quarter of 2007, not the remaining period. The three remaining cited procedures (numbers three, eight, and ten) concerned themselves with Koss fourth quarter gross or net sales figures. The limited value of the export sales territory procedure (number ten) was discussed in detail above. *See* p. 55 n.16. The other two procedures involved consideration of trends in Koss fourth quarter sales figures but made no reference to its April 30 or June 30 accounts receivable balances, lacked any effective link to the interim period testing, and used Koss IT system-generated data without supporting the reliability of that data.

Accordingly, we further find that in the 2006 and 2007 audits, Koeppel violated AU §§ 313.08 and 319.65 with regard to Koss's remaining period accounts receivable, even without considering her violations of PCAOB auditing standards with regard to Koss's interim period accounts receivable. Although there is a basis in the record for finding that Koeppel violated AU § 313.08 with respect to the remaining period audit work on accounts receivable in the 2008 audit, the OIP did not charge in the alternative that either she knew the rollforward was not done in 2008 or she believed that the rollforward was performed in 2008 in the same manner as the procedure was performed in 2006 and 2007 (*see* OIP ¶ 52), and the Division did not prove the former by a preponderance of the evidence. Consequently, we do not find any violation by Koeppel arising from the lack of an accounts receivable rollforward in the 2008 audit.

4. The inventory account

The charges against Koeppel in the inventory area concern the remaining period work in the 2006, 2007, and 2008 Koss audits. As with accounts receivable, existence of inventory was tested in each audit by applying principal substantive tests to the details of that asset account at the interim date of April 30. In that circumstance, "[s]ubstantive tests should be designed to cover the remaining period" in a way "that will provide a reasonable basis for extending to the balance-sheet date the audit conclusions from the tests of details at the interim date." AU §§ 313.03, .08. And, as noted, where, as here, the auditor performs only substantive tests, using information provided by the entity's information system, "the auditor should obtain evidence about the accuracy and completeness of the information" (AU § 319.65) and, having not "test[ed] the design and operating effectiveness of controls over financial information used in" substantive analytical procedures, "the auditor should," "[b]efore using the results obtained from substantive analytical procedures," "perform other procedures to support the completeness and accuracy of the underlying information" (AU § 329.16).

The Division argues that Koeppel violated these PCAOB auditing standards because audit procedures were not performed on the Koss IT system-generated reports that were used in the substantive testing of the remaining period activity in Koss's inventory account to determine the reports' accuracy and/or completeness, as Koeppel understood when she relied on that testing in forming and authorizing issuance of the 2006, 2007, and 2008 audit opinions. *E.g.*, DOB 6, 17, 34-35. Specifically, the Division contends that sufficient audit work was not performed in the 2006 audit on either the accuracy or completeness, or in the 2007 and 2008 audits the completeness, of the main report, or the completeness and accuracy of the other Koss reports, used in the substantive testing of the remaining period inventory activity to support the existence of inventory at June 30. DOB 13, 16-17 & n.70; DRB 11 & n.53; DPHS 48-51, 79-82.

Koeppel has contended that in each audit "[t]he substantive inventory procedures performed at interim, combined with the inventory rollforward and analytical procedures, provided ample evidence supporting [her] professional judgment that reasonable assurance had been obtained with respect to Koss's inventory" and that she "reasonably relied on that work in signing off on the issuance of the audit opinion." KPHS 41, 42-43. In particular, claiming to have been "very involved" in planning the Koss audits and "personally involved" in "reviewing the audit documentation" overall (*e.g.*, Tr. 727, 1237), she has argued that "[i]n order to extend the results of the substantive testing performed on inventory as of the interim date to the year-end, the auditors in each of the audits planned to perform and did perform various Remaining Period procedures." KPHS 86. Koeppel has described those procedures as: (1) so-called inventory rollforwards; (2) analytical procedures on the rollforwards; (3) certain testing in the 2007 and 2008 audits of a sample of items on the main report used in both the rollforward and the related analytical procedures; (4) inventory ratio analyses with respect to Koss's June 30 inventory balance; and (5) cut-off testing of inventory receipts as of June 30. KOB 18; KPHS 42 (citing Ex. R-507 at 96 (expert report)), 86. We have previously discussed in detail those procedures, all of which depended on Koss IT system-generated reports. *See* pp. 69-73 above.

As noted above, a cover page to the Koss inventory audit program in 2006, 2007, and 2008 stated that an inventory observation—the principal substantive audit test of the details of Koss's inventory account—would "be made prior to year end." Exs. J-54 at 1, J-153 at 1, J-250 at 1; *see* Tr. 369 (2006-2008 Staff/In-Charge Auditor), 1176-77 (Koeppel). The procedure identified in the 2006 Koss audit work papers as designed to cover Koss's remaining period inventory activity was the "Inventory Roll Forward." The procedures identified as designed to do so in the 2007 and 2008 audits were the rollforward; the tracing of a sample of items on the main Koss report used in the rollforward to source documents or to another Koss report (referred to by the work papers as "Rollforward Testing"); and analytical procedures comparing the totals of each component of Koss's inventory account activity in April and May of the current and prior fiscal years, based on the same Koss reports ("Inventory Roll Forward Analysis").

As with the accounts receivable rollforward, the beginning and ending account balances used in the inventory rollforward were trial balances. The remaining period inventory activity data came from Koss IT system-generated subledger detail reports and from trial balances of some half-dozen Koss inventory subaccounts. The main detail report used in the inventory rollforward was the monthly Detail Invoice Accounting Listing. The offsetting, reconciling items that flowed through the inventory rollforward for which that report provided the data totaled purported additions of May-June purchases for 2006, 2007, and 2008, of $3.6 million, $4.4 million, and $4.2 million, respectively; additions of May-June "labor added to inventory" for those years of $124,354, $29,859, and $63,337, respectively; subtractions of May-June cost of sales of $3.6 million, $3.7 million, and $3.9 million, respectively; and several other categories of generally smaller items. Two other Koss subledger detail reports contributed data to the rollforwards for those years for May-June returns (additions of $159,132, $127,104, $139,693, respectively) and May-June scrap from returns (subtractions of $47,773, $47,603, $73,685, respectively). Koss trial balance reports contributed data for those years used to calculate the inclusion of net May-June prepaid inventory of +$337,167, -$316,454, and -$365,890, respectively, and the inclusion of net May-June inventory in transit of -$329,073, -$583,225, and +$617,220, respectively, as well as May-June data for several other miscellaneous items. Exs. J-33 at 1-7, J-127 at 1-6, 9, J-222 at 1-5, 8.

In the inventory area, the rollforward itself in 2006 and the rollforward and two associated procedures in 2007 and 2008 played an important role in the Koss audits. In the 2006 audit, the rollforward was the only other work paper referenced on the inventory audit program together with the interim period inventory observation testing work papers. *See* Ex. J-33 at 8; Ex. J-54 at 4. According to the audit documentation, "Per the inventory rollforward, the amounts appear to be properly stated." Ex. J-33 at 5. In both the 2007 and 2008 Koss audits, the inventory audit program categorized certain tasks as "Year End" and, within that section, specifically referred to "the roll forward period." To one of those work steps was attached the work paper containing the rollforward and the rollforward testing (Exs. J-127 at 10, J-222 at 9; Exs. J-153 at 5, J-250 at 6) and to another was attached the rollforward analysis (Exs. J-128 at 6, J-223 at 7). For both 2007 and 2008, the rollforward testing work paper explained the role of the procedure: "As physical inventory count was taken prior to year-end on 4/30/[07 or 08], GT will test activity between count date and year-end to further validate the year-end inventory balance." Exs. J-127 at 7, J-222 at 6. The conclusion drawn from that procedure in 2007 was, "Per review of the above testing, GT notes receipts [and all shipments] are properly recorded as of 6/30/07" (Ex. J-127 at 7, 8) and in 2008 was, "Based on the above, it appears that inventory receipts [and shipments] have been properly accounted for in May and June 2008" (Ex. J-222 at 6, 7). The conclusion drawn from the rollforward in 2008 was, "Based on the above, it appears that inventory-related activity has been appropriately accounted for in May [and June] 2008." *Id.* at 2.

Yet, in 2006 no audit procedures were applied to the Koss IT system-generated reports used in the inventory rollforward to determine their reliability. In the 2007 and 2008 audits, ten inventory receipts and ten inventory shipments each from May and June were traced from the Detail Inventory Accounting Listing to underlying documents or to another Koss system-generated report. But none of this tracing of a small number of entries on one of the reports used in the rollforward addressed items that might have been omitted from that report, as audit team members acknowledged at the hearing. *See* pp. 71-72, 161-63 above; Tr. 1099-1100 (Koeppel claims this tested accuracy of the report before adding, without explanation, that it was also "designed to be a completeness test"). Nor did it provide evidence about the reliability of the other reports on which the rollforward depended.

As in the accounts receivable area, Koeppel claims that the reliability of the reports was determined "through the roll forward process" itself. Tr. 1092. We reject that argument here for the same reasons we rejected it there. And the rollforward analytical procedures compared only one month of remaining period inventory activity with the year before (May), did not, for example, compare the two months of the period with each other or with any prior period in the fiscal year, and the auditors relied for their expectations on prior-year Koss IT system-generated data, when no more audit work had been performed than in the current year on the reliability of the data. *See, e.g.,* p. 139 n.41 above. The lack of audit work on the reliability of Koss IT system-generated reports appropriate to the role they played in the designated remaining period audit testing constituted a fundamental inadequacy in all of that testing that created an important opening for misstatement due to error or fraud in a major area of the audit.[51/]

It is no answer to this deficiency for Koeppel to cite the inventory receipts cut-off testing and analytical procedures that included inventory in calculating two fiscal year-end ratios and comparing them to the prior year ratios. Any evidence the ratio analyses might have provided about remaining period inventory activity was limited by their consideration, due to the nature of the procedure, of inventory only as one factor in a ratio, their significantly different June 30 inventory balances from those used in the rollforward procedures, their use of fiscal year-end inventory balances, and their failure to support the reliability of Koss IT system-generated data on which they depended. The cut-off testing, performed using an inventory listing by invoice that apparently was used in the interim testing, was limited to a small number and amount of transactions, immediately around April 30 and June 30, only six of which each year were within the remaining period. Indeed, a Koss audit team member testified that similar shipping cut-off testing was performed to obtain evidence that items were booked in the right period rather than relied on as evidence of the existence of the fiscal year-end account balance. *See* p. 158 above. This is consistent with the stated conclusion from the 2007 and 2008 cut-off testing that "inventory cutoff controls were in place and operating effectively" at period end (*see* Ex. J-121 at 2, 4; Ex. J-217 at 1, 3), though the use of the language of controls testing in the work paper runs afoul of the undisputed fact that

[51/] The procedure documented on the 2007 and 2008 inventory audit programs of "Scan the entries in the general ledger inventory control account during the rollforward period for unusual activity" was subject to the same flaw, for it consisted of "review" of the Detail Inventory Accounting Listings for May and June. Exs. J-153 at 5, J-250 at 6.

there was no audit testing of the operating effectiveness of controls over critical assertions for the audit period (*see, e.g.*, Tr. 1025, 1287, 1468 (Koeppel)). And as to the Koss IT system-generated reports used in that other cut-off testing, Koeppel and others described the testing as "supporting the reports' accuracy" rather than completeness. *See* KPHS 38 n.19; Tr. 401-03, 713-14.

Moreover, there was no effective link between the analytical procedures that Koeppel cites as covering Koss's remaining period inventory activity and the interim period inventory testing. If the interim testing had been tied to Koss's general ledger at April 30,[52/] such a link might have been established by audit procedures and evidence showing that the Koss June 30 inventory account balance reports, to which the Koss Inventory Listing used in the interim testing apparently was tied at June 30 and from which the ratio and rollforward analyses drew their data, reliably reflected Koss's general ledger and underlying accounting records. But, as we have discussed at length above, the auditors relied on Koss IT system-generated reports in substantive audit testing in the pertinent areas without applying the necessary audit procedures and obtaining the necessary evidence to determine their reliability for the audit purposes they served. *See, e.g.,* Tr. 703-04, 713-14 (2007-2008 Staff Auditor acknowledges limitations of tying to report or tying reports used in substantive testing to trial balance as evidence of reliability).[53/] Additionally, in tying the Inventory Listing to the June 30 trial balance, the auditors did not check that the total balance and each of the subtotals stated on the Listing was in fact the sum of all the the individual items on that report or subsection, further undercutting the efficacy of the reconciliation. *See* p. 71 above.

For the foregoing reasons, we find that in the 2006, 2007, and 2008 Koss audits, Koeppel relied on audit work, known to her, that was inadequate on Koss's remaining period inventory activity to form and authorize the issuance of unqualified opinions on its financial statements for those fiscal years, without having directed that necessary further audit work be done. She therefore violated AU §§ 313.08, 319.65, and 329.16.

[52/] The Division developed evidence at the hearing that this was not done. *See* pp. 70-71 above. As a Grant Thornton training program Koeppel attended in January 2007 noted, "Don't waste time on an incomplete file! Would you select A/R confirmations sample or Inventory price test sample items before you tied out your detail to the ending balance? No, you wouldn't." Ex. J-130 at 20; *see* Tr. 796-802 (Koeppel); Ex. J-306 at 1. But Koeppel was not charged with violations regarding the interim period inventory audit work, nor has the Division argued that the violations with which she was charged concerning the remaining period audit work stemmed in part from flawed interim work.

[53/] All but the first point made above about the ratio analysis also apply to a trend analysis performed in each audit that compared the current and prior fiscal year-end inventory balances. *See* Exs. J-47, J-147 at 3-4 (reviewed by Koeppel), J-234 (same).

VI.

Sarbanes-Oxley Act Section 105(c)(4) authorizes the Board to impose "such disciplinary or remedial sanctions as it determines appropriate," subject to certain limitations, on registered public accounting firms or associated persons of such firms if the Board "finds, based on all of the facts and circumstances," that the firm or person has violated PCAOB rules and auditing standards. 15 U.S.C. 7215(c)(4). With respect to a proceeding against an associated person, such as here, Section 105(c)(5) specifies that a suspension, bar, or limitation on the activities or functions of such person, as well as a certain range of civil money penalties "for each violation" (above $110,000 and not more than $800,000 for the period of the Koss audits in question), "shall only apply" to "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard" or to "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." 15 U.S.C. 7215(c)(5); 17 C.F.R. 201.1001, Table 1.[54/]

[54/] The Commission has stated that "the knowledge, recklessness, and negligence standards" in Section 105(c)(5) "are similar to the standards for Commission discipline of accountants under Rule 102(e) of [its] Rules of Practice (now also codified in [Securities] Exchange Act Section 4C by Sarbanes-Oxley)" and that accordingly the Commission's "interpretations of the Rule 102(e) standards inform [its] analysis under Sarbanes-Oxley Section 105(c)(5)." *Gately & Assocs., LLC*, SEC Rel. No. 34-62656, 2010 WL 3071900, *11 (Aug. 5, 2010); *see Hatfield*, 2013 WL 3339647, *23 n.141. Nevertheless, despite certain similarities in these standards, Rule 102(e) contains not only the language "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards," which is similar to Section 105(c)(5), but also the language "that indicate[s] a lack of competence to practice before the Commission" (17 C.F.R. 201.102(e)(1)(iv)(B)(2)), which nowhere appears in Section 105(c)(5). *See Gately*, 2010 WL 3071900, *11 n.31. That additional language is considered a separate element in a Rule 102(e) proceeding. *See Dearlove*, 2008 WL 281105, *28 ("We must now determine whether Dearlove's conduct, though only negligent, nonetheless demonstrates a lack of competence to practice before the Commission."); *John J. Aesoph*, SEC Rel. No. 34-78490, 2016 WL 4176930, *16 (Aug. 5, 2016) ("We must 'make a specific finding that the conduct indicates a lack of competence' because 'two isolated violations of applicable professional standards…may not pose a threat to the Commission's processes'") (citation omitted), *appeal filed*, No. 16-3830 (8th Cir. Oct 3, 2016). Koeppel cites no support in the statute for her assertion that the imposition of certain sanctions under Section 105(c)(5) "requires proof of intentional misconduct or repeated acts of negligent conduct demonstrating a lack of competence to practice public accounting" (KOB 1) or for her suggestion that sanctions may be imposed only for "'incompetence or a lack of integrity'" (KOB 19, 37 (quoting phrase in initial decision)). Furthermore, by contrast to Section 602 and Rule 102(e), which require more in an SEC proceeding for improper professional conduct by an accountant than one instance of ordinary negligence,

Negligence on the part of the auditor is “the failure to exercise reasonable care.” *See Dearlove,* 2008 WL 281105, *31. Negligence is a standard that is “objective, measured by the degree of the departure from professional standards rather than the intent of the accountant.” *See Kevin Hall, CPA*, SEC Rel. No. 34-61162, 2009 WL 4809215, *7 (Dec. 14, 2009); *see also Dearlove v. SEC*, 573 F.3d 801, 805 (D.C. Cir. 2009) (“an objective inquiry whether [the auditor’s] conduct was unreasonable in the specific factual circumstances at issue”); *McNeeley*, 2012 WL 6457291, *15. PCAOB auditing standards provide the standard of care for assessing the auditor’s conduct. *Hatfield*, 2013 WL 3339647, *21.

As discussed in depth above, Koeppel was responsible for complying with PCAOB auditing standards in the performance of the 2006, 2007, and 2008 Koss audits and, in the ways we have found, she failed to do so. Proceeding to a sanctions analysis, the next step would be to consider—by reference to Section 105(c)(5)’s categories of either “intentional or knowing conduct, including reckless conduct” (subsection A) or “negligent conduct” (subsection B)—the “degree[] of deviation” by her from PCAOB standards in the three audits. *See Dearlove*, 573 F.3d at 805; *accord Hall*, 2009 WL 4809215, *7 (“degree of the departure” from applicable standards). Then, for negligent conduct, we would consider whether there were repeated instances of such conduct, each resulting in a violation of applicable standards.

Based on the nature, frequency, and extent of Koeppel’s violations, we conclude that her conduct constituted repeated instances of negligence, each of which resulted in a violation of PCAOB standards. We now turn to determining appropriate sanctions.

A. Koeppel Engaged in Repeated Instances of Negligent Conduct, Each Resulting in a Violation of Applicable PCAOB Standards.

Koeppel was repeatedly negligent in leading the 2006, 2007, and 2008 Koss audits. Despite the importance of Koss’s journal entries, net sales, special sales allowances, accounts receivable, and inventory to those audits, despite her years of auditing experience, despite her knowledge of the facts pertinent to the violations, and despite circumstances that called her attention to some of the very issues in this case, she failed time and time again to take proper account of (1) the limitations of the audit work and evidence, (2) countervailing information, and (3) the interrelationship of weaknesses in the work, as these matters related to the very foundation for the testing in these areas—data reliability and a basic element of an important substantive test of net sales. In these areas, the audits were characterized by acceptance of precisely

Section 105(c)(4) authorizes the Board to sanction an auditor “based on a single instance of negligent conduct.” *See PCAOB Proposed Rules Relating to Investigations and Adjudications*, SEC Rel. No. 34-49454, 2004 WL 555401, *14 (Mar. 19, 2004).

what the company and, in particular, its small accounting department, told the auditors about its systems and processes and precisely what it gave them to test and by satisfaction with multiplying procedures performed on a potentially incomplete data set.

Koeppel was the auditor with final responsibility for the audits and authorized the issuance of audit reports expressing unqualified opinions on Koss's financial statements for those fiscal years. She claimed to act on the understanding that "I have ultimate responsibility for the opinion that is issued on those financial statements," including determining whether or not an opinion can be issued, and "have the obligation to make sure that the audit is planned and performed properly, using my engagement team, and that the workpapers support the opinion that we render." Tr. 1156-57; *see* Tr. 1167-68 ("I am responsible, again, based on the work done by my team and reviewed, that the work is complete and has been executed as planned, and that all the necessary work steps are done prior to the release of the audit"). This is consistent with our discussion of her responsibilities in Section V(A) above. She was an experienced auditor who began her career in 1986 with a large national audit firm, joined Grant Thornton in 2002, led the audit practice at that firm's Milwaukee office for the next six years, and served as the office's managing partner from April 2008 to April 2011. As discussed, Koeppel knew the facts about the audit work and evidence pertinent to our findings of violations.

The audit work led by Koeppel on Koss's journal entries purportedly responded to the fraud risk of management override of internal controls, which required specific attention in each audit. Work papers reviewed by her in the audits recognized the need for "an added sensitivity to management's ability to override" any controls "the entity has in place to address the identified fraud risk factors"; the need to address possible "lack of segregation of duties" in Koss's small accounting department, which could give "rise to fraudulent financial reporting"; the need to "closely review unusual journal entries and perform journal entry control testing"; and the need to "substantively test journal entries throughout the period and thoroughly review journal entries posted around year-end." Koeppel agrees with the Division that to achieve the objectives of testing specific entries for fraud under AU § 316, a complete journal entry population is necessary.

Yet in all three of those audits Koeppel failed to notice or address a fundamental flaw in the testing of Koss's journal entries. For the identification and testing of specific journal entries, Koeppel relied on the paper binders prepared and maintained by Koss's accounting department from which items admittedly could have been excluded. She did so knowing that this was not "the preferred method to get the information" and that the auditors could not "identify numbers that were missing," which would have been a "nice" alternative "way to get comfort" about completeness, because Koss's journal entries were not "numbered sequentially." Koeppel has conceded that the so-called upstream/downstream method she accepted instead in those audits to test completeness would not identify any journal entry missing from both sets of binders and that no work step in the audit programs specifically addressed that issue.

There was no good reason for Koeppel's failure. A PCAOB inspection comment on the 2005 Koss audit and 2006 and 2007 Grant Thornton audit training courses specifically called her attention to the issue of the completeness of the journal entry population subject to fraud testing. She has admitted to attending and agreeing with that firm training, has stated that she took the inspection comment "very seriously," and has confirmed that she had the comment in mind in the 2006 Koss audit, which was in progress at the time of the comment, and in the 2007 and 2008 Koss audits. Such "obvious reminder[s]" of the requirements of professional standards made Koeppel's "failure to comply all the more glaring." *McNeeley*, 2012 WL 6457291, *16. Moreover, at the time of the inspection comment, the firm's regional professional standards partner discussed with Koeppel the general concept of "upstream/downstream" testing, which Koeppel believed could be performed in "multiple ways." But, despite this need for and availability of guidance, this focus on the issue as important, and the existence of specific complicating factors at Koss, Koeppel "did not see a need to elevate" to "somebody outside of the engagement team" how that rough idea might specifically be applied, or "the variety of procedures that we could use," to determine completeness under the particular circumstances of the Koss audits, and she neither provided input into nor learned why Audit Manager chose the particular "upstream/downstream" procedure used in the 2006-2008 Koss audits. Koeppel's passive approach in this respect underscores the unreasonableness of her conduct on the facts of this case.

The excuse Koeppel offers for not noticing or addressing the flaw in the journal entry testing is inadequate. She argues, mostly in highly general, indirect fashion, that completeness was addressed not only by the upstream/downstream procedure but also by a combination of other audit work. The other work she cites consists of journal entry control-related procedures, an assessment that the inherent risk of fraud at Koss was low, an understanding that a so-called update report was generated by Koss's IT system whenever a journal entry was posted to Koss's general ledger, an examination of the numbering of journal entries in the binders and of physical characteristics of update reports in the binders, and obtaining general representations from Koss personnel that they were not aware of any fraud at the company. According to Koeppel, that other audit work made the difference in "provid[ing] a reasonable basis" for her "judgment that sufficient evidence supported the completeness of the journal entry population." *E.g.*, KPHS 67-68. What this amounts to is Koeppel using a potentially incomplete set of paper records as the validation for mere assertions about company processes and for spotty information about company IT access controls, from which, along with the apparent internal consistency of the set of records and more untested, general representations, she then, in circular manner, leapt to the conclusion that the set of paper records was complete. Examination of the particulars of that work for sanctions purposes only confirms that Koeppel's conduct was negligent.

What Koeppel claims as her chief other source of support for completeness is that Koss had "effective controls over its journal entry processes," a "strong control environment," and a "well-controlled process." *E.g.*, Tr. 1311, 1328, 1493-94; KPHS 68.

By this, she means that, in her view, the duties in Koss's accounting department were appropriately segregated, related IT system access controls on who could post journal entries were in place, and VP-Finance and President/CEO functioned as "monitoring controls." Tr. 826, 828-29, 1141-44, 1147-49, 1305-06, 1311, 1451, 1493-94.

Koeppel's attempt to explain why she believed the audit work on these internal control-related matters showed that the binders were complete is vague, oblique, and insubstantial. Namely, she contends that "[t]he auditors understood and confirmed through testing that controls were in place over the journal entry processes which prevented any individual from single-handedly posting improper journal entries." KPHS 67; *see* Tr. 1306. In the first place, this claim misconceives the issue here as whether "improper journal entries were [] being made" by a particular method ("singlehandedly posting"), based on consideration of identified fraud risk factors (*e.g.*, KOB 42). Rather, the issue is whether a complete population of journal entries was obtained for fraud testing to address the more general risk of management override of controls, which can occur in unpredictable ways. Moreover, Koeppel depends decisively on generalizations based on the very binders whose completeness was at issue, takes an exaggerated view of the purported "testing" of Koss journal entry controls, relies excessively on mere "understanding" of how its processes were supposed to work, and glosses over serious weaknesses in that understanding as well as negative information. The resulting shortfall in the reality of the evidence, compared to her characterization of the evidence, about how the controls actually operated causes her claim to fail on her own terms, as it does her justification for focusing solely on "single-handed[]" posting of improper journal entries and paying no discernible attention to the possibility of collusion—that collusion would "represent[] a total breakdown in [Koss's] control structure" (Tr. 1493).

Specifically, by Koeppel's own account, the auditors' testing of segregation of duties in Koss's accounting department played a key role in the audits. But the examination of department-provided paper records of journal entries for who created and signed off on them did not mean that those were the only entries actually recorded or that they reflected the only way in which journal entries came to be recorded at Koss.

Apart from that, what Koeppel refers to as "testing" of Koss journal entry access controls consisted of nothing more than the following. First, the audit team obtained from Koss's outside IT contractor a list of Koss user profiles in 2006, read it, and accepted VP-Finance's explanation for why, contrary to a 2004 recommendation by the Grant Thornton IT specialists and inconsistent with a work step in the audit program, no review of the list was performed by Koss. Part of that explanation had been rejected by the specialists as "not a control when assessing the effectiveness of segregation of duties and user access controls," and the other part of it left the auditors again to rely on the paper binders. Second, the audit teams made general inquiries in the 2007 and 2008 audits of Koss's IT contractor and increasingly only of Koss's accounting department about any changes, again dependent for validation on the binders. *E.g.*, Tr.

1300. And third, the audit teams obtained fragmentary, limited information about journal entry access controls through observation in the one-time "walkthrough" in each audit.

The so-called testing of access controls was far less substantial than suggested by Koeppel. For example, there is no claim or evidence that the auditors did any other "testing" of whether access of Koss personnel to post journal entries changed over time; performed any procedure to determine the time period covered by or the completeness of the 2006 user profile list or to test information the IT contractor used to generate the list, despite a direction in the audit program to "[v]erify the completeness and accuracy of the list by comparing it to the system settings"; or gained an understanding of all user profiles in Koss's IT system, much less tested the operating effectiveness for any of the audit periods of any IT controls over access to post journal entries. No controls over the creation or maintenance of the journal entry binders were even identified in the audits. Negative information in Grant Thornton's 2004 IT review further diminished the already slight value of the access control work as a source of evidence that the binders were complete. Specifically, the firm's IT specialists found that, by all appearances: Koss's lack of regular user access/segregation of duties reviews created a risk of inappropriate access rights and excessive access to its financial systems, a matter management seemed to disregard and the auditors never identified any response to; Koss's IT contractor focused on functionality with little understanding or appreciation of IT control standards; Koss relied completely on the contractor and shared that focus; and Koss's controls for managing user access to a key software system were probably ineffective.

The last of the journal entry control-related audit work that Koeppel cites as evidence of completeness of the binders was her "understanding" that VP-Finance and President/CEO acted as "monitoring controls." But the auditors' understanding that VP-Finance reviewed all journal entries was part of the segregation of duties work, which, as pertinent to this point, consisted merely of obtaining assertions from accounting department personnel and examining those journal entries they offered up as a complete set. Even ignoring the possibility of collusion and assuming unfailing review of all journal entries by VP-Finance, she was a certified public accountant, unlike her subordinates, had worked at Koss longer, was identified by Koss as an officer and senior manager, was one of two Koss officers who signed its Form 10-Ks, and so, for all the auditors knew, she could have played a dominant role in the creation or revision of journal entries presented to her by subordinates. This would have been inconsistent with heavy reliance on her as a "monitoring control." And again, she worked part-time, and there is no indication electronic approval was needed to submit a journal entry.

The auditors' understanding of any role President/CEO might have played in monitoring journal entries was vague and untested, lacking in direct information, documentary support, and basic, critical details, such as how he would have reviewed any individual journal entries—for all the auditors knew, by using the same paper binders they used. A review of financial statements was not, in fact, the same as a review of the myriad journal entries that contributed to the total balances. The heavy reliance placed by Koeppel on President/CEO (and VP-Finance, for that matter), a member of management, as a control in this context is even less justifiable for numerous reasons. Among other things, a number of identified fraud risk factors in the audits counseled against such reliance; journal entry fraud testing is meant to address the risk of management override of controls; and management itself commented in response to the 2004 IT review that "our IT is in the hands of the users," that "[e]ach area is responsible for it[s] data and the accuracy of that data," and that the apparent functioning of an accounting process as "a well oiled machine" determines the appropriateness of IT governance and controls related to that process, which was in line with the IT contractor's focus but contrary to the audit firm's IT specialists' view.

Koeppel also claims to have relied on "the low assessed risk of fraud," referring to a component of the inherent risk assessment in each audit (*see* Exs. J-70 at 3, J-178 at 3, J-278 at 3; Exs. J-71 at 1, 2, 4, J-179 at 1, 2, 4, J-279 at 1, 2, 4), to establish the adequacy of the evidence of completeness of the binders. She suggests, as with her separate argument about Koss's supposedly "well-controlled environment," that, because of the low assessed inherent risk of fraud, items would not have been omitted from the binders in the first place and so not much audit effort was necessary to determine completeness. *See, e.g.*, Tr. 1493 (when asked if risk of items missing from both binders occurred to her during the audits, Koeppel responded, "I've searched my brain a lot. You know, I have to say no."). But in so arguing, Koeppel fails to account for the impact of the weakness of the so-called journal entry control-related audit work, especially in light of the negative information in Grant Thornton's 2004 IT review; for the particular fraud risks and risk factors identified in the audits; and for the difference between identified fraud risks and the risk of management override of controls. *See* pp. 91-110, 113-26 above. Her argument about the low assessed inherent risk of fraud proceeds as if that were the only determinant of the risk of material misstatement due to fraud, as though her view about Koss's "well-controlled environment" took control risk entirely out of the equation. In fact, inherent risk and control risk are both components of the risk of material misstatement, and merely because inherent risk of fraud was assessed as low did not mean that the risk of material misstatement due to fraud was low. As summarized immediately above, the journal entry control-related work was far less substantial than Koeppel portrays it and was undercut by the negative information in the 2004 IT review. There is no evidence that the extent of support for completeness she claims to have drawn from the low inherent fraud risk assessment can compensate for her wrongly inflated view of the value of the journal entry control-related work and the lack of response to the IT review information. Even as to the inherent fraud risk component itself, an assessment of low risk did not mean no risk. Further, "[b]ecause fraud is usually concealed, material misstatements due to fraud are difficult to detect" (AU § 316.31), and the response to identified fraud risks, which is required in any audit (*e.g.,* AU § 316.02), is not the same as the response to the more amorphous risk of management override of controls. *See, e.g.*, AU § 316.42. We see no evidence or argument about anything particular in the response to identified fraud risks in the Koss audits that provided an extra measure of effectiveness capable of reducing the otherwise necessary response to the risk of management override.

Koeppel otherwise claims to have relied, for evidence the binders were complete, on sources that contributed little or no further support under the circumstances. First, she cites unverified assertions that an update report was invariably generated whenever a journal entry was recorded. The assertions were obtained from Koss's outside IT contractor—whose knowledge and appreciation of IT control standards were criticized by the Grant Thornton IT specialists—and from members of Koss's small, significantly autonomous accounting department—whose representations and journal entry binders were used by the auditors in each audit as virtually the only evidence about the operation of internal controls over the journal entry process. The contractor's assertions did not give Koeppel any visibility into whether an update report, even if printed without fail or interference, made it from the printer into the binders provided to the auditors.

Second, any "additional comfort" that Koeppel was "dealing with a complete population of journal entries" that might have come from "gain[ing] an understanding" of Koss's "standard numbering system" and "investigat[ing] any unexpected deviations" (KRB 7) was minimal. As she knew, "consistent numbers" were used only for "standard entries" and investigating "gaps in sequential numbering" in the items in the binders was not an effective method of "identify[ing] missing journal entries" because "Koss's numbering system for its journal entries was not sequential." KRB 7; KPHS 30; Tr. 1322-23. Firm training she attended during the relevant period specifically pointed out that a client-prepared "list of journal entries" "would probably not include [any] fraudulent entries" and "[c]opies of fraudulent journal entries would likely not be in [a] binder" of "'paper copies of journal entries maintained by the [client].'" Ex. J-130 at 20-22.

Similarly, even if the pages of individual, multi-page update reports that were provided to the auditors in the binders were connected by perforated edges, that did nothing to prevent one or more individuals from excluding other update reports, which were separately printed, from the binders as part of a fraud, which, of course, is usually concealed (*see, e.g.*, AU §§ 316.09, .31, .62). Yet in this regard Koeppel was content simply to note the absence of signs that "pages had been ripped out" (KOB 17) or "ripped apart" (KRB 6). Lastly, mere general representations by management and staff at Koss that they were not aware of any fraud at the company could not fill the large holes remaining in the evidence of completeness in each of the Koss audits at issue.

For all of the foregoing reasons, Koeppel did not have a reasonable basis for concluding that the journal entry population subject to fraud testing in the Koss audits was complete. Her violations in the journal entry area were negligent.

We reach the same conclusion about Koeppel's violations with respect to Koss's revenue and inventory. She understood that Koss's recorded revenue and inventory presented a reasonable possibility of material misstatement and that they called for "additional attention" and "heav[y]" "focus" in the audits. In this regard, of the three revenue-related areas charged and in which we have found violations, net sales was by far the largest line item on Koss's income statement, special sales allowances was by far the largest component of Koss's reported accrued liabilities, and accounts receivable was one of the two largest assets on Koss's balance sheet. Inventory, the other charged area in which we have found violations, was the other largest reported asset.

At the outset, we note that Koeppel failed to recognize the implications of the flawed journal entry testing for the data reliability work and related substantive testing in these last four areas. Journal entries recorded in Koss's IT system could affect the content of its IT system-generated reports and alter the data, contemporaneously or after the fact, for the period reflected in the single-point-in-time printouts. But due to the inadequate audit work on completeness of the journal entry population, the auditors would not have necessarily received and effectively tested those entries for fraud, calling the reports into doubt. As an example, this, in turn, complicates the auditor's consideration, for purposes of applying principal substantive tests to the details of an asset or liability account as of an interim date rather than as of the balance sheet date, of whether "the [entity's] accounting system will provide information concerning the balances at the balance-sheet date and the transactions in the remaining period that is sufficient to permit investigation" of "(a) significant unusual transactions or entries (including those at or near year-end), (b) other causes of significant fluctuations, or expected fluctuations that did not occur, and (c) changes in the composition of the account balances," such that "evidential matter related to" these matters would be "sufficient for purposes of controlling audit risk." AU § 313.07; *see* AU § 313.05 ("if the auditor assesses control risk at the maximum during the remaining period, he should consider whether the effectiveness of certain of the substantive tests to cover that period will be impaired"). Furthermore, the "expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements" depends in part on "the availability and reliability of the data used to develop the expectation." AU § 329.11. Management override of controls, which the journal entry testing in the Koss audits did not properly address, could "allow[] adjustments outside of the normal period-end financial reporting process to have been made to the financial statements" that "might have resulted in artificial change to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions." AU § 329.10.

With regard to the net sales analytical procedures, the record shows that in each audit analytical procedures were clearly important tests of Koss's net sales. The expectation is a fundamental element of the procedure. Yet, Koeppel countenanced expectations of differences from prior-year sales amounts that were stated in such a vague manner they did not capture identified changed circumstances with any meaningful level of precision and did not enable the auditors to identify differences that might be potential material misstatements. *See* pp. 51-53, 132-40 above.

With regard to the reliability of Koss IT system-generated data used in the substantive audit testing of net sales, special sales allowances, accounts receivable, and inventory, Koeppel decided not to test the operating effectiveness of Koss's internal control in those areas for any of the audit periods in question. According to Koeppel, PCAOB auditing standards "do not require an auditor who is not relying on internal controls to perform such tests of controls." KOB 27. This is not always true. *See, e.g.,* AU § 319.03 & .66 (circumstances may exist in which "it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions"), .65 ("the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level"). But assuming for purposes of this case that it is true here, a reasonable auditor must come to terms with the implications of that lack of testing.

Koeppel did not. She purported to do so through what Audit Manager called "a highly substantive audit to validate the balances and assertions." *See* Tr. 1254, 1336 ("We audit the output of the system, rather than the system itself.") (Koeppel); Ex. D-4 at 35 & Ex. R-509 at 182 (Audit Manager's investigative testimony). But integral to substantive audit testing is the reliability of the internal company information used in that testing. A Grant Thornton training program Koeppel attended in January 2007 stressed, "Don't waste time on an incomplete file! Would you select A/R confirmations sample or Inventory price test sample items before you tied out your detail to the ending balance? No, you wouldn't." Ex. J-130 at 20; *see* Tr. 796-802 (Koeppel); Ex. J-306 at 1. Although Koeppel claims that "[t]he record is clear that substantial evidential matter was obtained [in each Koss audit] about the accuracy and completeness of the information produced by Koss's IT system which [she] believed provided a reasonable basis for her professional judgments regarding the issues criticized in the OIP" (KPHS 22), what is clear from the record is that her analysis of this issue was riddled with flaws.

For most of that claimed "substantial evidential matter," Koeppel fell back on audit planning activities. First, in effect, she treated an understanding of internal control as though it were testing of internal control. Koeppel was adamant in testimony that, based on the "good evidence" and "audit support related to that a system is operating effectively" that was provided by understanding Koss's controls over "critical cycles [and] financial reporting, which includes IT and governance," she "could certainly come to the conclusion" that those controls "were designed and operating effectively," that Koss "had an internal control process" over IT that "was designed and operating effectively," and that its IT system could reasonably be relied upon in the the audits. Tr. 1292-94, 1297-99, 1466-73. So uncritical was she in accepting reports generated from Koss's IT system at face value, based on understanding rather than testing of controls, that when asked at the hearing if the auditors at any point went behind Koss's IT system to look at what the reports were actually drawing from, she said that "we didn't think to do that, again, because they were system-generated reports." Tr. 1488.

As discussed, that understanding cannot bear the weight Koeppel places on it as evidence of data reliability. The understanding was built on a 2004 Grant Thornton IT "review," without taking proper account of its limitations and negative information; mere representations by Koss personnel; Koss's use of a "reputable" computer system that assertedly had not been "extensively" altered; the administration (though not the use) of Koss's IT system by an outside consultant who was the only person "authorized" to implement system changes and who, along with Koss's controls related to managing program changes and user access, had been criticized by the audit firm's IT specialists; the supposed use for business purposes of Koss reports provided to serve a distinct audit purpose; and stray, incomplete observations in a walk-through of certain system access controls and automated features of an "integrated" accounting system that appeared to be in place at Koss at one point in time, which at best scratched the surface of issues such as data entry error, system error, and management override of controls. It was unwarranted and unreasonable for Koeppel to assume that this understanding of how Koss's internal controls were supposed to work for the period covered by each audit meant that the controls actually operated that way.

The second aspect of audit planning that Koeppel has tried to use to support her conclusion about the reliability of Koss IT system-generated information is the assessment of low inherent risk in each of the audits. Not being in a position from the audit work to identify or determine how Koss's internal control operated over the audit period, Koeppel had to take control risk seriously in determining the nature, timing, and extent of audit procedures. As she knew, the "'B' approach" of the audit programs, which equally applied to a low-inherent-risk-high-control-risk audit and a high-inherent-risk-low-control-risk-audit, was not tailored to specific issues of the reliability of client IT system-generated data posed by the former type of audit. *See, e.g.*, Tr. 1439-44. She "didn't feel it was necessary" in the Koss audits "to tailor in a whole bunch of more steps" than "the steps" the audit program already was "designed to incorporate [] into our work" to address the reliability of Koss's reports. Tr. 1498. Moreover, there is no evidence that the audit programs, as produced by the audit firm's software, specifically reflected certain Koss system limitations and internal control information, discussed above, that mattered to the audits. Indeed, Koeppel identified a control deficiency of escalating seriousness to her in the revenue area. Yet in every discussion of the reliability of Koss system-generated data, she cavalierly disregards control risk, focusing only on low inherent risk, never on the combination of low inherent risk and high control risk. And, as noted above, even her narrow focus on inherent risk and overstatement cannot explain why so little, if any, audit work was done on completeness of the data.

Otherwise, Koeppel relies for evidence of completeness on her basic audit approach, which, according to her, "incorporates into" and "embeds" in "our testing various tests of reports" used in the substantive audit procedures, namely "tying back to a supporting document or doing a roll forward or tying to the general ledger [by way of a trial balance report] or tying to a subledger [report]." Tr. 1186-88, 1340, 1348-49, 1457-62. But she knew or should have known that, as explained in depth above, the mere mathematical agreement of balances or sums of balances of various reports does not necessarily mean that the transactions listed or purportedly reflected in the reports were valid or recorded correctly and that all of the transactions that occurred were recorded and reflected. In emphasizing tying IT system-generated general ledger reports and subledger detail reports to one another and to each other, Koeppel overlooks that this is not direct, detail testing of any report entry or reconciling item, and without sufficient support for the reliability of the data, the reconciliation becomes an all but meaningless exercise. The nature and small scale of what audit work was done to tie Koss reports to underlying source documents did not come close to compensating for these problems, as discussed in detail above. *See, e.g.*, pp. 89-91, 146-52 above.

For the foregoing reasons, Koeppel did not have a reasonable basis for her conclusions that the expectations were sufficiently precise for the net sales analytical procedures in which a significant difference from the recorded amount was expected. Likewise unreasonable were her conclusions that sufficient competent evidential matter had been obtained about the completeness of Koss's IT system-generated reports used in the pertinent substantive audit testing of Koss's net sales, special sales allowances, accounts receivable, and inventory to support the audit opinion she developed or to cover the remaining period in a way that provided appropriate audit assurance at the balance sheet date. Her conduct in all of these respects was negligent.

Having found that Koeppel's conduct in violating PCAOB auditing standards in the 2006, 2007, and 2008 Koss audits was negligent, we consider whether that misconduct consisted of repeated instances of negligence, each resulting in a violation. Whether an auditor's negligent conduct involves "repeated instances" of such conduct, "each resulting in a violation," is a question that arises not only in our application of Section 105(c)(5), but also in connection with Commission consideration, under Rule 102(e) of the Commission's Rules of Practice or Sarbanes-Oxley Act Section 602, of whether there are grounds to deny persons licensed to practice as accountants the privilege of appearing or practicing before the Commission. 15 U.S.C. 78d-3(b)(2)(B); Rule 102(e)(1)(iv)(B)(2). The Commission's consideration of the question is instructive. In interpreting Rule 102(e), the Commission has expressly defined "repeated" to mean, simply, "more than once." *Amendment to Rule 102(e)*, 1998 WL 729201, *9. As explained in the SEC's adopting release, "repeated instances" of negligence can encompass "as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits." *Id.* "By contrast," the release explained, "a single error that results in an issuer's financial statements being misstated in more than one place would not, by itself, constitute" repeated instances of negligent conduct. *Id.* *See also Hall*, 2009 WL 4809215, *7 (whether there are "repeated instances" of negligence depends on number of distinct instances of conduct, not on number of affected accounts); *accord Aesoph*, 2016 WL 4176930, *15 n.73; *see generally Dearlove*, 2008 WL 281105, *30 (finding repeated instances of at least unreasonable conduct by auditor).

Koeppel's negligence extended to three audit years, five distinct areas in each audit (journal entries and four financial statement accounts), and multiple types of violations within audit areas. Her violations involve, for example, inadequate support for the reliability of Koss data used in the substantive audit testing and other deficiencies in respective audit procedures on one of the accounts, deficient audit work on both interim and remaining period financial data for another account, and various failures over multiple accounts to perform certain presumptively mandatory procedures, to exercise due care, including professional skepticism, and to obtain sufficient competent evidential matter. By no stretch of the imagination can this conduct be viewed as a "single error" that "results in an issuer's financial statements being misstated in more than one place." Rather, it is repeated instances of negligence many times over. Thus, Koeppel is subject to the sanctions specified by Section 105(c)(5).

B. Koeppel's Violations Call for the Imposition of Strong Sanctions, Which in This Unusual Case Is Accomplished by Our Imposition of a Limitation on Her Activities and a Censure.

In determining the sanctions that are appropriate for Koeppel's violations, we consider the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, to carry out our statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports. *See* Sarbanes-Oxley Act Section 101(a), 15 U.S.C. 7211(a); *see also* Section 101(c)(5), 15 U.S.C. 7211(c)(5) (in identifying duties of Board, referring to objective "to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof" or "otherwise to carry out this Act, in order to protect investors, or to further the public interest"); *Hatfield*, 2013 WL 3339647, *26 ("'[T]he appropriate sanction depends upon the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings.'") (citation omitted). In making this determination, the Board also draws guidance from the grounds on which the Sarbanes-Oxley Act authorizes the Commission to disturb Board sanctions: a finding, with "due regard for the public interest and the protection of investors," that the sanction "is not necessary or appropriate in furtherance of this Act or the securities laws" or "is excessive, oppressive, inadequate, or otherwise not appropriate to the finding or the basis on which the sanction was imposed." Section 107(c)(3), 15 U.S.C. 7217(c)(3).

Koeppel's non-compliance with the above-identified PCAOB auditing standards in the 2006, 2007, and 2008 Koss audits, affecting five major audit areas in each of three audit years, was pervasive and protracted. As such, it reflected a deep-seated inability or unwillingness by Koeppel to understand and carry out her auditing responsibilities, despite her attempt to suggest otherwise at the hearing (*see* Tr. 1156-57, 1167-68; *see also* I.D. 7 (referring to her testimony, divorced from proper analysis of her conduct), cited by KOB 36). The failures in one audit year compounded the failures in the next, as shown, for example, by Koeppel's heavy reliance on prior year recorded numbers as the expectations for the net sales analytical procedures. As the SEC has noted, "'the existence of a violation raises an inference that it will be repeated.'" *Hatfield*, 2013 WL 3339647, *25 (quoting *Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004)). Koeppel committed the violations despite having, by the time of the audits, spent about 20 years in public accounting (*see, e.g.,* Tr. 1203), auditing issuers since 1986, which should have equipped her to comply with the standards at issue. She has shown no recognition of the wrongful nature of her conduct, and the record provides no assurance that she would respond differently if faced with similar circumstances in a future issuer audit. Koeppel unequivocally testified that she wanted to resume auditing issuers. Tr. 1208; *see* KRB 45 & n.22 (asserting she is "not unfit to continue auditing" and should not be subjected to a "career-ending bar from public accounting").[55/]

[55/] On December 2, 2015, while this matter was pending, the SEC issued an order instituting and settling proceedings against Koeppel based on charges that in other issuer audits she engaged in improper professional conduct under SEC Rule of Practice 102(e). *See Melissa K. Koeppel, CPA*, SEC Rel. No. 34-76537, 2015 WL 7755467 (Dec. 2, 2015). That settlement relates to her conduct while serving as engagement partner for two Grant Thornton issuer clients other than Koss. Specifically, without admitting or denying the Commission's findings, Koeppel consented to the entry of an order finding that, during the 2009 and 2010 year-end audits of one company and the 2009 third-quarter review and 2009 year-end audit of another company, she violated multiple PCAOB auditing standards by, among other things, failing to properly plan the audits, exercise due care and professional skepticism, obtain sufficient evidence, and properly supervise audit assistants. The Commission concluded that Koeppel's conduct "involved repeated instances of unreasonable conduct, each resulting in violations of PCAOB standards and indicating a lack of competence, and also satisfies the standard of highly unreasonable conduct resulting in violations of PCAOB standards in circumstances in which heightened scrutiny was warranted." She was ordered to pay a $10,000 civil penalty and was denied the privilege of appearing or practicing before the SEC as an accountant with leave to apply for reinstatement after five years. The settled order stated that "Koeppel, age 54, is a [CPA] licensed to practice in Wisconsin," that "[s]ince 2012, Koeppel has been employed by Grant Thornton as a managing director, outside the audit-services practice," and that any application for reinstatement by her "must satisfy the Commission that," among other things, she "has resolved all disciplinary issues with the PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (other than reinstatement by the Commission)." The order is no legal impediment to our determining appropriate sanctions to address the particular misconduct in the present case. *See, e.g., Thomas C. Trauger*, CPA, SEC Rel. No. 34-51259, 2005 WL 464862, *1 & n.5 (Feb. 25, 2005); *Hunter Adams*, SEC Rel. No. 34-52144, 2005 WL 1963483, *3 & n.6 (July 28, 2005); *cf. Perpetual Secs., Inc.*, SEC Rel. No. 34-56613, 2007 WL 2892696, *12 & n.68 (Oct. 4, 2007).

The auditor "is not an insurer and his or her report does not constitute a guarantee," but the audit report "is based on the concept of obtaining reasonable assurance," through the exercise of due professional care and the related observance of standards of field work, including obtaining and evaluating sufficient competent evidential matter, that "the financial statements are free of material misstatement, whether caused by error or fraud." *E.g.*, AU §§ 230.02, .10, .11, .13, 326.02, .22, .25. The investing public relies heavily on auditors to fulfill their professional duties in auditing public companies to help assure corporate compliance with federal securities law and disclosure of accurate and reliable financial information. *McNeeley,* 2012 WL 6457291, *12; *see, e.g.*, *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984); *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005); *Marrie v. SEC*, 374 F.3d 1196, 1200-01 (D.C. Cir. 2004); *Touche Ross & Co. v. SEC*, 609 F.2d 570, 580-81 (2d Cir. 1979); *Dearlove*, 2008 WL 281105, *30. An issuer audit thus stands as a vital line of defense against incorrect, unreliable financial information that can harm the markets and investors, such as resulted from the fraud at Koss that was ongoing throughout the three audits and led to so large a restatement. The audit cannot serve its purpose when it falls as short as the audits were proven to have done here of the rigorous, objective evidence gathering and analysis required by PCAOB standards.

Relying extensively on the initial decision, Koeppel opposes sanctions by arguing that: (1) she cannot be found to have committed violations based on her own conduct, which was favorably "attested to" by "those [other audit] team members [who] testified," but only by attributing or imputing conduct of "junior members of the engagement teams" to her through some uncharged or invalid means; (2) "extensive work [was] done on the Relevant Audits" with "professionalism and competence [by] the engagement team members"; (3) the Division is merely "second-guessing" her "professional judgments" after discovery of the fraud at Koss, and any departures from PCAOB standards were "mistakes" or "pure errors of judgment" that do not rise to the level of negligence; (4) she has "rightfully defended the reasonableness of her judgments and actions" in this case; (5) "[a]ny finding of violation of PCAOB standards would have a very severe impact on [her], personally and professionally," and that she "has already been penalized," in that she "is no longer performing audits," "no longer manages Grant Thornton's Wisconsin practice," and "has lost her position as a Grant Thornton partner [and moved to a managing director role], significantly impacting her financially," as "the principal wage earner [in her family], with college-aged children"; and (6) at most, an appropriate sanction "would be limited to censure and/or supplemental professional education." KOB 3 n.2, 35-39; KRB 44-45; Tr. 1209-10, 1427-28.

Koeppel's reliance on the initial decision is misplaced. The decision declared that it would "briefly address the facts and considerations that would bear upon the Board's sanctions determination" if the Board were to review the decision. I.D. 85. Yet the initial decision's subsequent sanctions discussion (I.D. 85-88) derived from the same faulty premise as Koeppel's first contention above, which concerns not sanctions but the basis for liability in this case and which we have thoroughly rejected in Section

V(A). The decision also purported to refute a Division argument "that the Board has authority to impose disciplinary sanctions on Koeppel even if her own conduct did not amount to negligence" (I.D. 87-88), which is irrelevant to our resolution of this case, in which we have found repeated instances of negligent conduct by Koeppel. As to a short, separate, earlier section of the initial decision ("Conclusions Regarding the Work of the Engagement Teams," I.D. 73-75), certain favorable statements there about the audit work, which Koeppel cites for her second contention above, are mere summary, general assertions not reconciled with the hearing officer's own findings of violations and not grounded in the record or proper analysis, set forth herein. Nor is it any more of an answer to the Board's analysis of the audit work to say that junior members of the engagement teams involved in the performance of the failed work vouch for that work and for Koeppel's attentiveness to it. *See, e.g., McNeeley*, 2012 WL 6457291, *17.

Contrary to Koeppel's third contention, her departures from PCAOB standards that we have discussed in depth in this final decision went well beyond merely making "mistakes" or "pure errors of judgment." They constituted repeated instances of negligence. References cited by Koeppel in the auditing standards to professional judgment simply reflect the unremarkable fact that decisions about procedures to be performed in an audit depend on engagement-specific facts that an auditor learns during the audit process and require the exercise of informed judgment about how to respond to such information as it becomes available. *See, e.g.*, AU § 326.13. This detracts in no way from the fact that "an auditor must exercise, not [her] 'inclination,' but [her] 'professional judgment' and that judgment must be 'guided by sound' auditing principles, among which are a 'thorough…search for evidential matter, AU § 326.23, and an 'attitude that includes a questioning mind and a critical assessment of audit evidence,' AU § 230.07." *McCurdy*, 396 F.3d at 1263. And there is no basis for suggesting that the Board is somehow unable or unwilling to distinguish the evidence bearing on conduct during the audits from after-the-fact developments. Our extensive analysis of the audit work clearly reflects that the "gravamen of the charge against" Koeppel "is not her failure to uncover the fraud itself, but her failure to adhere to [applicable auditing standards] during [each] audit." *McNeeley*, 2012 WL 6457291, *12.

Regarding Koeppel's fourth contention, no one disputes that a respondent in an auditor disciplinary proceeding "has the right to present a vigorous defense." *Id.* at *18. And this decision reflects the time and care we have devoted to analyzing and addressing in detail her many and fact-intensive arguments. But it is also appropriate to take account of the fact that those arguments provide no inkling of any recognition that her conduct was deficient in the serious ways we have concluded are demonstrated in the record. We are therefore left with no reason to believe that, absent appropriate sanctions, Koeppel will not repeat such lax conduct, which is a relevant consideration.[56/]

[56/] *Gately*, 2010 WL 3071900, *14, *16; *see, e.g., Aesoph*, 2016 WL 4176930, *17; *S.W. Hatfield, CPA*, SEC Rel. No. 34-73763, 2014 WL 6850921, *10 (Dec. 5, 2014); *Michael C. Pattison, CPA*, SEC Rel. No. 34-67900, 2012 WL 4320146, *10 (Sept. 20,

Koeppel's fifth contention concentrates exclusively on the potential impact of sanctions on her well-being, without consideration of the implications of her misconduct for the public interest and the protection of investors. Collateral consequences to a respondent do not outweigh the need to "protect the interests of investors and further the public interest" by, among other things, investigating, adjudicating, and sanctioning conduct that threatens those interests. *See* 15 U.S.C. 7211(a), 7211(c)(5); *see also, e.g., McNeeley*, 2012 WL 6457291, *19; *Gary N. Kornman*, SEC Rel. No. 34-59403, 2009 WL 367635, *9 (Feb. 13, 2009) ("'[f]inancial loss to a wrongdoer as a result of his wrongdoing' does not mitigate the gravity of his conduct") (quoting *Robert L. Wallace*, SEC Rel. No. 34-40654, 1998 WL 778608, *5 (Nov. 10, 1998)), *aff'd*, 592 F.3d 173 (D.C. Cir. 2010); *Ashton Noshir Gowadia*, SEC Rel. No. 34-40410, 1998 WL 564575, *4 (Sept. 8, 1998); *Hunter v. SEC*, 879 F. Supp. 494, 501 (E.D. Pa. 1995) (there is no general right "not to be injured in one's reputation or business prospects" by the fact of investigative or disciplinary actions that are authorized by Congress) (citing cases).

Addressing the specific conduct here, we determine that Koeppel poses too great a risk to investors to be in a position to continue auditing public companies until appropriate sanctions provide a reason to believe she can and would do so in compliance with PCAOB standards. We recognize this is not a case in which "virtually no audit procedures" were performed in an audit. *See, e.g., John L. Van Horn*, SEC Rel. No. 209, 1988 WL 1705575 (Nov. 1, 1988) (settled order) (permanently barring auditor from appearing or practicing before SEC for violations of applicable standards in three audits). Nor is this a case the Division contends is rife with obvious warning signs of material misstatement or involves an overall high risk of material misstatement for any financial statement assertion at issue. *See, e.g., Mark E. Laccetti, CPA*, PCAOB File No. 105-2009-007 at 62-63 (Jan. 26, 2015) (barring auditor, with leave to petition to associate after two years, and imposing $85,000 civil penalty for violations in one audit), *aff'd*, SEC Rel. No. 34-78764, 2016 WL 4582401 (Sept. 2, 2016), *appeal filed on other grounds*, *Laccetti v. SEC*, No. 16-1368 (D.C. Cir. Oct. 31, 2016). And this is not a case that in some respects shares both of those types of features. *See, e.g., Hatfield*, 2013 WL 3339647 (sustaining imposition of permanent associational bar for violations in three audits); *Gale Moore, CPA*, PCAOB File No. 105-2012-004 (Aug. 23, 2016) (for misconduct in one audit, barring auditor from association with a registered public accounting firm, with proviso that she may petition to associate after two years and that

2012); *see also Horning v. SEC*, 570 F.3d 337, 346 (D.C. Cir. 2009); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 100 (2d Cir. 1978); *Rita J. McConville*, SEC Rel. No. 34-51950, 2005 SEC LEXIS 1538 at *60 (June 30, 2005), *aff'd*, 465 F.3d 780 (7th Cir. 2006); *ZPR Inv. Mgmt Inc.*, SEC Rel. No. 40-4249, 2015 WL 6575683, *29 (Oct. 30, 2015) (failure to recognize the wrongfulness of conduct "is relevant to our consideration of the public interest and demonstrates a risk of future violations") (collecting cases), *aff'd in relevant part*, 861 F.3d 1239, 1255 (11th Cir. 2017).

weight will be given in considering such petition to completion by her of 50 hours of professional education, and restricting her activities for two additional years).

Rather, the salient feature of this case is audit work that lacked the rigor and effectiveness necessary to have reliably identified red flags in the first place. This is a serious failure in its own right that calls for strong sanctions, especially when widely repeated in three audits. Without a proper foundation for audit testing, such as adequate audit work to determine the completeness of a set of items being tested, simply multiplying procedures applied to those items can be meaningless. That was a major, fundamental flaw in all three audits, with which Koeppel's sixth contention fails to come to terms.

We determine that, at this stage, it suffices, to protect against Koeppel's demonstrated capacity for the negligence at issue in this case and to encourage compliance by her and others with their responsibilities under PCAOB auditing standards in the future, to limit Koeppel's activities by restricting her, until after two years, in any audit with respect to an issuer, from serving as an engagement partner or engagement quality reviewer; from performing audit procedures or otherwise assisting an engagement partner in fulfilling his or her planning or supervisory responsibilities; from performing engagement quality review procedures or otherwise assisting an engagement quality reviewer in fulfilling his or her responsibilities in an engagement quality review; from consulting on issues arising in the audit; and from exercising authority either to sign a registered public accounting firm's name to an audit report for an issuer or to consent to an issuer's use of a previously issued audit report. This sanction is well situated within the range of measures imposed in other adjudicated auditing cases, such as those just discussed and *Dearlove*. *See Dearlove,* 2008 SEC LEXIS 223, *111 & n.120 (noting actions taken in litigated Rule 102(e) auditor cases, from denial of the privilege of appearing or practicing before the SEC with leave to seek reinstatement after one to five years to permanent denial and denying auditor that privilege with leave to seek reinstatement after four years for misconduct in one audit).

We also censure Koeppel. A censure additionally serves to '"notif[y] the public of [her] past misconduct' even after the terms of the other sanctions have been fulfilled." *Moore*, PCAOB File No. 105-2012-004 at 51 (quoting *Salvatore F. Sodano*, SEC Rel. No. 34-59141, 2008 WL 5328801, *3 (Dec. 22, 2008)); *see, e.g., Philip L. Spartis*, SEC Rel. No. 34-64489, 2011 WL 1825026, *13 (Dec. 1, 2010) (censures "alert the public, including other [regulatory authorities], of the unacceptability of [the actor's] conduct").

These sanctions will impress upon Koeppel the seriousness of her violations and her auditing responsibilities. In imposing these specific sanctions under these unique circumstances, the Board is mindful of the time that has passed since the conduct at issue and the commencement of this proceeding, as well as the likely impact of the supervening impositions ordered by the SEC. The sanctions protect investors and further the public interest, and none of Koeppel's arguments, and none of the circumstances presented by this case, suggest that they are excessive or oppressive.

VII.

As set forth above, we have found that the Division proved by a preponderance of the evidence charges in the OIP that Koeppel violated PCAOB rules and auditing standards, and we have determined appropriate sanctions under the circumstances for those violations.

An appropriate order will issue.[57/]

By the Board (Board Member Harris not participating)

[57/] We have considered all of the parties' contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Melissa K. Koeppel, CPA, Respondent	PCAOB File No. 105-2011-007 **ORDER IMPOSING SANCTIONS** December 29, 2017

On the basis of the Board's opinion issued this day it is

ORDERED that Melissa K. Koeppel may not, until after two (2) years from the effective date of this order, in any audit with respect to an issuer, serve as an engagement partner (as that term is defined in PCAOB Auditing Standard 1201) or engagement quality reviewer (as that term is used in PCAOB Auditing Standard 1220); perform audit procedures or otherwise assist an engagement partner in fulfilling his or her planning or supervisory responsibilities; perform engagement quality review procedures or otherwise assist an engagement quality reviewer in fulfilling his or her responsibilities in an engagement quality review; consult on issues arising in the audit; or exercise authority either to sign a registered public accounting firm's name to an audit report for an issuer or to consent to an issuer's use of a previously issued audit report.

And it is further

ORDERED that Melissa K. Koeppel is censured.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the

date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board (Board Member Harris not participating)

Phoebe W. Brown

Phoebe W. Brown
Secretary

December 29, 2017

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of S. Brent Farhang, CPA,

Respondent

PCAOB File No. 105-2016-001

FINAL DECISION

March 16, 2017

Appearances

C. Ian Anderson and Craig L. Siegel, New York, NY, for the Division of Enforcement and Investigations

Scott Vick, Vick Law Group, APC, Los Angeles, CA, for Respondent

I.

S. Brent Farhang, CPA, has petitioned for Board review of the hearing officer's initial decision, which found on summary disposition that Farhang refused to cooperate with a Board investigation and which ordered sanctions. Farhang concedes that he refused to appear for investigative testimony but contends that the Board lacks the authority to require him to appear or to impose a civil money penalty for his refusal and that a civil money penalty is otherwise inappropriate in this case. For the reasons discussed below, we reject Farhang's arguments and impose a censure, a bar from association with a registered public accounting firm, and a $50,000 civil money penalty.

II.

Farhang is a 57-year-old certified public accountant who at all relevant times was a person associated with a registered public accounting firm as defined in Section 2(a)(9) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(9), and PCAOB Rule 1001(p)(i). Index to the Record on Review, Record Document (R.D.) 22c, Ex. 11. At the time of his refusal to testify, Farhang was a partner with a registered public accounting firm in Los Angeles, California where he worked on issuer audits. R.D. 23d, Ex. 1 at 8-9. Prior to then, he was associated with another registered public accounting firm, Goldman Kurland and Mohidin, LLP (GKM or the Firm), also in Los Angeles. *Id.* As pertinent here, GKM audited the financial statements of a certain issuer, referred to here as Issuer A, for the fiscal year ended June 30, 2012. *Id.* at 17. Farhang was the audit manager on that engagement. R.D. 23d, Ex. 13.

III.

A. The PCAOB opened an investigation of GKM and its associated persons.

On December 16, 2014, the Board issued an Order of Formal Investigation (OFI) pursuant to Sarbanes-Oxley Act Section 105(b)(1), 15 U.S.C. 7215(b)(1), and PCAOB Rule 5101(a)(1) authorizing the Division of Enforcement and Investigations to conduct a formal investigation of the Firm and its associated persons. R.D. 23d, Ex. 14. The OFI concerned potential violations of PCAOB rules and auditing standards related to the Firm's audits of the financial statements of certain issuers, including Issuer A. Pursuant to the OFI, the Division issued an Accounting Board Demand (ABD) to the Firm in December 2014 requiring the production of documents and information that concerned, among other things, the Issuer A audit. R.D. 23d, Ex. 15; *see* PCAOB Rule 5103.

On June 30, 2015, the Division issued ABDs to Farhang as well as to Ahmed Mohidin, who served as the engagement partner for the Issuer A audit, and one other person associated with the Firm, requiring them to produce certain documents and information and appear for testimony at the PCAOB's New York offices. R.D. 23d, Exs. 23-25. As previously agreed to by the Division and counsel jointly representing Farhang and Mohidin, the June 30, 2015 ABDs set Mohidin's testimony for September 14-17, 2015 and Farhang's testimony for September 30 and October 1, 2015. R.D. 23d, Exs. 23, 25-26. The Division also agreed, at the request of Farhang and Mohidin, to reimburse them for the reasonable costs associated with traveling to New York for testimony. R.D. 23d, Ex. 27. Along with the June 30, 2015 ABDs, the Division enclosed copies of a PCAOB form (Form ENF-1), which informed Farhang and Mohidin of their rights and duties as witnesses and the consequences of a refusal to give testimony in connection with a Board investigation. In response to the June 30, 2015 ABD issued to him, Farhang produced six emails and a signed PCAOB Witness Background Questionnaire on July 14, 2015. R.D. 23d, Exs. 28-29.

B. Mohidin, represented by the same counsel as Farhang, gave testimony suggesting possible misconduct by Farhang.

As scheduled, the Division took testimony from Mohidin on September 14-17, 2015 at the PCAOB's New York office. R.D. 23d, Ex. 30. During the testimony, at which counsel for Mohidin and Farhang was present, the Division questioned Mohidin regarding, among other things, the Issuer A audit. R.D. 23d, Exs. 30-31. As part of that questioning, the Division showed Mohidin several documents indicating Farhang may have made late modifications to the Issuer A audit work papers without properly documenting those modifications, in potential violation of PCAOB Auditing Standard No. 3, *Audit Documentation*. R.D. 23d, Ex. 32. Mohidin testified that he was “troubled” by the documents. *Id.* at PCAOB-FARHANG-5422-001367.

C. Farhang withdrew his agreement to provide testimony and refused to appear.

Approximately one week later, on September 25, 2015—more than three months after Farhang agreed to appear in New York for testimony and five days before he was scheduled to give testimony—Farhang’s counsel informed the Division that Farhang would not appear for testimony, stating that “Mr. Farhang has decided that he will exercise his right to decline to appear for testimony.” R.D. 23d, Ex. 33 at 3. The Division responded the same day by email stating as follows:

> I understand your email to mean that Mr. Farhang refuses to provide any testimony in the above-referenced matter, and not just that he refuses to testify next week. If that is not correct, please let me know immediately. A refusal to provide testimony as required by an Accounting Board Demand constitutes noncooperation under the Act and Board rules, and is grounds for instituting a disciplinary proceeding. See Board Rule 5110(a).

R.D. 23d, Ex. 33 at 3. In response, Farhang’s counsel reiterated, “Mr. Farhang is exercising his right to decline to testify in this matter.” *Id.* at 2. The Division sought to clarify with counsel why Farhang was refusing to testify and provided an additional warning that Farhang’s conduct would constitute noncooperation:

> With respect to Mr. Farhang, please provide a detailed explanation as to the basis for his belief that he has a right to not appear for testimony in this matter. Mr. Farhang’s rights with respect to his obligation to appear for testimony are set forth in the ENF-1 enclosed with his ABD, and in the Act and Board Rules, and those rights do not include the prerogative to simply refuse to appear for testimony at any time. We consider his refusal to constitute noncooperation with an investigation and will proceed accordingly.

Id. at 1. In response to the Division’s further inquiry, Farhang’s counsel replied (*id.*):

> The PCAOB cannot force any person to testify. Any person who does not wish to testify in response to an ABD has a right not to testify. The PCAOB might take the position, as it has in other cases, that there are consequences. If you reach that point, Mr. Farhang reserves the right to assert any defense or bring any claim, including a claim for lack of jurisdiction and constitutional claims.

Farhang failed to appear at the PCAOB's New York office to give testimony on September 30, 2015, and the same day the Division sent a letter to Farhang advising him that Division staff intended to recommend that the Board commence a disciplinary proceeding to determine whether Farhang had refused to cooperate with a Board investigation. R.D. 23d, Exs. 34-37; R.D. 17, Answer (Ans.) 1 ¶¶ 1-3, 2 ¶ 7, 3 ¶ 18. The letter notified Farhang that he could submit, by October 7, 2015, a written statement to the Division, pursuant to PCAOB Rule 5109(d), setting forth his position as to whether a disciplinary proceeding should be commenced. R.D. 23d, Ex. 34.

On October 7, 2015, Farhang, through counsel, submitted a short statement of position (SOP) responding to the Division's September 30, 2015 letter. R.D. 23d Exs. 36, 37. The SOP did not offer any alternative dates or arrangements for Farhang's testimony but instead asserted, among other things, that he had "severely limited financial resources and more important financial obligations," could not "afford to retain counsel to represent him," and noted that his native language is not English. R.D. 23d, Ex. 37. Farhang concluded his SOP by asserting that he had otherwise complied with the June 30, 2015 ABD and was only a manager at the time of the relevant audits and reviews, and by asking that the Board "defer taking any disciplinary action against him." *Id.* When contacted by the Division on October 7, 2015, Farhang's counsel stated that he continued to represent Farhang in this matter, "but [Farhang] can no longer afford to have me do anything." R.D. 23d, Ex. 38.

On October 26, 2015, the Division sent Farhang a letter addressing his SOP and informing him that the information Farhang had provided in the SOP did not constitute "valid reasons for Mr. Farhang to refuse to testify." R.D. 23d, Ex. 40 at 1. Among other things, the Division pointed out that PCAOB Rule 5401 permitted Farhang to represent himself. *Id.* The Division also noted that documents produced by Farhang and the Firm "show that he can communicate fluently in English" but offered, "if Mr. Farhang reasonably believes that an interpreter is necessary," to "make one available." *Id.* at 2. The Division reconfirmed its willingness to reimburse Farhang for his flight to New York, hotel accommodations, and other reasonable expenses associated with his appearing for testimony. *Id.* Alternatively, the Division offered to take his testimony in Los Angeles or at another convenient location. *Id.* The Division concluded its letter by requesting that Farhang let the Division know, once again, whether he would agree to appear for testimony, and to do so no later than November 2, 2015. *Id.* The Division received no response by that date and sent a follow-up email to Farhang's counsel on November 9, 2015. R.D. 23, Ex. 41 at 1.

The same day, Farhang's counsel emailed the Division a response that repeated some of the points in the SOP and concluded that for the reasons set forth therein, "Mr. Farhang is unable to testify." R.D. 23d Ex. 41 at 1.

D. The Board instituted disciplinary proceedings.

On January 12, 2016, the Board issued an Order Instituting Disciplinary Proceedings against Farhang pursuant to Sarbanes-Oxley Act Section 105(c), 15 U.S.C. 7215(c), and PCAOB Rule 5200(a)(3). R.D. 1. On February 10, 2016, the hearing officer issued an order deeming Farhang in default because he had failed to answer or attend the initial prehearing conference. R.D. 10. Pursuant to that order, on February 24, 2016 the Division filed a motion for a default decision, which asked the hearing officer to determine the proceeding against Farhang and sanction him with a censure, a permanent bar from being associated with any registered public accounting firm, and a $75,000 civil money penalty. R.D. 12.

Prompted by the Division's motion, which Farhang's counsel characterized as "making an unconstitutional demand for a $75,000 civil money penalty against Farhang" (R.D. 14a at 3), the counsel filed a notice of appearance on February 27, 2016 (R.D. 13) and a motion to set aside the default on March 2, 2016 (R.D. 14). The brief in support of that motion stated that the counsel "agreed to represent Farhang without charge" and that "Farhang's failure to appear at the Initial Prehearing Conference and file an Answer grew out of his inability to pay counsel to research, apply and articulate [the] complex arguments [which constitute his defense] that very few lawyers even understand." R.D. 14a at 3, 4. On March 3, 2016, the hearing officer set aside the default. R.D. 15.

Farhang filed an answer on March 11, 2016. The answer admitted, among other things, that he "did not appear for testimony as scheduled and has repeatedly refused to appear for testimony on any other date" in connection with a Board investigation while he was an associated person of a registered public accounting firm. Ans. at 1, ¶¶ 1-3. It denied, however, that he had an obligation to comply with the ABD. Ans. at 1, ¶ 2.

E. The hearing officer granted the Division's motion for summary disposition and ordered sanctions, and Farhang appealed.

The Division and Farhang filed cross-motions seeking summary disposition under PCAOB Rule 5427(d). *See* R.D. 15 at 4; R.D. 16b at 17, 28-29; R.D. 18 at 1;

R.D. 22; R.D. 22a at 1, 23; R.D. 23; R.D. 23a at 12-15. After briefing, the initial decision found that it was undisputed that Farhang repeatedly refused to comply with an ABD to appear for testimony during the Division's investigation of the Firm. R.D. 27, Initial Decision (I.D.) 12. The decision rejected Farhang's arguments that his refusal to testify was legally justified and concluded that he "failed to cooperate with a Board investigation without a valid justification." I.D. 12-17. It ordered that he be censured and barred from associating with a public accounting firm and also concluded that "Farhang will be ordered to pay a civil monetary penalty of $75,000, but such payment will be waived based on Farhang's demonstrated inability to pay a civil penalty." I.D. 22.

On August 22, 2016, Farhang petitioned for Board review of the initial decision. R.D. 28, Petition for Review (Pet.). The last appeal brief was filed on December 14, 2016. R.D. 34, Reply Brief (Reply Br.). Neither party requested oral argument.[1/]

IV.

PCAOB Rule 5427(d) provides that "[t]he hearing officer shall promptly grant a motion for summary disposition if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a disposition as a matter of law." This rule, in substance, parallels Rule 56 of the Federal Rules of Civil Procedure, as well as Rule 250 of the SEC Rules of Practice. Under these provisions, the question is whether the record as a whole demonstrates the existence of any factual disputes that must be resolved through a hearing. *See R.E. Bassie & Co.*, SEC Rel. No. AAE-3354, 2012 SEC LEXIS 89, *27-*28 (Jan. 10, 2012); *see also, e.g., National Amusements, Inc. v. Town of Dedham*, 43 F.3d 731, 735 (1st Cir. 1995).

Sarbanes-Oxley Act Section 105(b)(3), 15 U.S.C. 7215(b)(3), *Noncooperation with Investigations*, authorizes the Board to impose sanctions if a registered public accounting firm or associated person "refuses to testify, produce documents, or otherwise cooperate with the Board in connection with an investigation," and PCAOB Rule 5300(b) provides for sanctions if such a firm or person "has failed to comply with an accounting board demand, has given false testimony or has otherwise failed to cooperate in an investigation." There is no genuine issue of material fact concerning whether Farhang refused to appear for testimony in response to the ABD issued to him on June 30, 2015, and he concedes that he so refused.

[1/] On September, 13, 2016, the PCAOB instituted and settled disciplinary proceedings against the Firm and Mohidin for violating PCAOB rules and auditing standards. *Goldman Kurland and Mohidin, LLP and Ahmed Mohidin, CPA*, PCAOB Rel. No. 105-2016-027 (Sept. 13, 2016).

The questions before us for decision are whether any of Farhang's arguments as to the legal authority of the Board to sanction him for such misconduct are meritorious and, if not, what sanctions are appropriate.

V.

Sarbanes-Oxley Act Section 105(b)(3) authorizes the Board to sanction firms and associated persons for refusing to cooperate with an investigation. That authority is fundamental to the Board's mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports," Sarbanes-Oxley Act Section 101(a), 15 U.S.C. 7211(a), and to its corollary duty, set out in Section 101(c)(4), 15 U.S.C. 7211(c)(4), to "conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms, in accordance with section 105." *See Bassie*, 2012 SEC LEXIS 89, *38-*39 ("investigations play a crucial role in furthering" the goals of the PCAOB). The Board's authority to sanction refusals to cooperate promotes the prompt and full cooperation by firms and their associated persons with PCAOB investigations and is integral to the regulatory system established by Congress. *Cf. Charles C. Fawcett, IV*, SEC Rel. No. 34-56770, 2007 WL 3306105, *6 (Nov. 8, 2007).

Longstanding precedent holds that securities industry self-regulatory organizations (SROs), which are charged with the duty to effectuate the purposes of various federal laws and on which the PCAOB is modeled, have authority to sanction firms and associated persons for failure to cooperate with an investigation. *See, e.g., United States v. Solomon*, 509 F.2d 863, 869-70 (2d Cir. 1975); *Howard Brett Berger*, SEC Rel. No. 34-58950, 2008 WL 4899010, *7 (Nov. 14, 2008) (discussing origin and necessity of NASD's authority to sanction regulated persons for failure to respond to requests for information), *aff'd*, 347 Fed. Appx. 692 (2d Cir. Oct. 1, 2009) (unpub.). The government, to make best use of its limited resources, commonly relies on "private organizations to effectuate the purposes underlying federal regulating statutes," and the courts have recognized that with that responsibility must also fairly come the authority to sanction persons within their jurisdiction for noncooperation, for there would be "a complete breakdown" in regulation if those organizations did not "carry most of the load of keeping [regulated persons] in line and have the sanction of discharge for refusal to answer what is essential to that end." *Solomon*, 509 F.2d at 869-70.[2/]

[2/] The PCAOB was "modeled on private self-regulatory organizations in the securities industry—such as the New York Stock Exchange—that investigate and discipline their own members subject to Commission oversight." *Free Enterprise Fund v. PCAOB,* 561 U.S. 477, 484 (2010). The PCAOB was established by statute as a non-profit corporation that is not an agency or establishment of the United States

The Board, in the exercise of its statutory authority and consistent with the precedent in the SRO context, has rendered several prior decisions in litigated noncooperation cases, stating foundational principles in this area, in addition to issuing numerous settled orders.[3/]

The first of the adjudicated cases was *R.E. Bassie & Co.*, PCAOB Rel. No. 105-2009-001 (Oct. 6, 2010). In that case, Bassie at first cooperated with a Board investigation by providing testimony, but he and his firm, of which Bassie was sole proprietor, refused to respond to subsequent requests for documents. The Board sanctioned Bassie and his firm based on respondents' repeated failure to produce documents in response to two ABDs "despite the Division's repeated warnings, over several months, that such noncooperation could result in disciplinary sanctions." *Id.* at 12. Explaining the importance of cooperation with investigations, the Board stated that "[c]onducting investigations in an appropriate and timely manner depends upon

Government. Sarbanes-Oxley Act Sections 101(a) & (b), 15 U.S.C. 7211(a) & (b). In *Free Enterprise Fund*, the Supreme Court stated that, although "the parties agree that the Board is 'part of the Government' for constitutional purposes," "Board members and employees are not considered Government 'officer[s] or employee[s]' for statutory purposes." 561 U.S. at 484, 485-86 (citations omitted).

[3/] *See, e.g., Deloitte Touche Tohmatsu Auditores Independentes*, PCAOB Rel. No. 105-2016-031 (Dec. 5, 2016) (imposing, among other sanctions, an $8 million civil money penalty for combination of noncooperation and other charges); *Arturo Vargas Arellano, CPC*, PCAOB Rel. No. 105-2016-045 (Dec. 5, 2016) (barring engagement partner and imposing $50,000 civil penalty for combination of noncooperation and other charges); *Tony Zhicong Li, CPA*, PCAOB Rel. No. 105-2016-023 (June 14, 2016) (permanent bar on partner for refusing to continue with scheduled testimony after appearing the first day and failing to comply with subsequent ABD); *Edith LAM Kar Bo*, PCAOB Rel. No. 105-2016-002 (Jan. 12, 2016) (three-year bar on Hong Kong-based partner for refusing to appear for testimony); *Paul W. Marchant, CPA*, PCAOB Rel. No. 105-2014-006 (May 6, 2014) (three-year bar on senior manager for providing false documents and testimony in investigation); *Chintapatla Ravindemath*, PCAOB Rel. No. 105-2010-005 (Mar. 16, 2010) (permanent bar on senior manager for refusal to appear for testimony); *Siva Prasad Pulavarthi*, PCAOB Rel. No. 105-2010-004) (Mar. 16, 2010) (same); *Moore & Assocs., Chartered*, PCAOB Rel. No. 105-2009-006 (Aug. 27, 2009) (revocation of firm's registration and permanent bar on firm president for combination of noncooperation and other charges; no civil penalty because "Moore has agreed to pay a civil monetary penalty to the U.S. Securities and Exchange Commission in the matter styled *SEC v. Michael J. Moore and Moore & Associates Chartered*, Case No. 2:09-cv-01637 (D. Nev. Filed August 27, 2009)").

registered firms' and associated persons' compliance with demands for documents and testimony made pursuant to the Board's authority under the Act. Noncooperation frustrates the oversight system by impeding the Board's ability to determine whether violations have occurred for which sanctions should be imposed, including sanctions that would protect investors from further violations, and thus deprives investors of an important protection that the Act was intended to provide." *Id.* at 11. The Board rejected respondents' arguments that the sanctions should be mitigated by their late offer to the Board to make the requested documents available for review and by the lack of evidence of direct harm to investors. *Id.* at 11-12. In concluding that revocation of the firm's registration and a bar on the auditor's association with any registered accounting firm were warranted, the Board noted that respondents at first told the Division they intended to cooperate but then simply stopped responding; the Board found that "such noncooperation indicates a lack of sufficient regard for Board processes and authority designed by statute to protect investors." *Id.* at 12.

In *Bassie,* the Board also determined that a civil money penalty was "plainly appropriate." *Id*. at 15. We noted, among other things, that the respondents "disregarded their obligation to cooperate with the Board's investigation," that such noncooperation "is a harm to investors and markets that factors into a sanctions analysis," and that a civil penalty for noncooperation is appropriate as a deterrent to those who would otherwise be encouraged to not cooperate in order to "prolong the period of their registration and maximize their income from issuer audit work before being sanctioned." *Id.* at 16. In ordering a $75,000 penalty in that case, we observed "this is well below the maximum penalty that we could impose" but "nonetheless reflects the seriousness of Respondents' noncooperation, including the harm to investors from the possibility that such noncooperation may have prevented the Board from uncovering evidence that would have revealed failures or violations warranting an even steeper penalty" and "is sufficient to deter similar noncooperation by others." *Id.* at 19-20.

The Securities and Exchange Commission (Commission or SEC) affirmed the Board's imposition of sanctions. *Bassie*, 2012 SEC LEXIS 89. In its decision, the Commission confirmed the principles set forth by the Board, reiterating, for example, that "[t]he Board's investigatory power is central to its ability to carry out its statutory responsibilities and fulfill its goals in the public interest," *id.* at *48, and that "failure to cooperate in an investigation is very serious misconduct," *id.* at *40. The Commission concluded that revocation and an associational bar were warranted because, among other things, "noncooperation indicates a lack of sufficient regard for Board processes and authority designed by statute to protect investors." *Id.* at *42. The Commission further determined that "[t]he need for deterrence…supports a civil penalty," and that, "[w]hile imposing a larger penalty in this case might provide an even greater deterrent against similar [noncooperation] by other registered public accounting firms and their associated persons, a civil penalty of $75,000 appears sufficient to have a deterrent effect on a firm such as Bassie's." *Id.* at *48, *51-*52. The Commission underscored that "[t]he Board's power to impose appropriate sanctions in disciplinary proceedings is fundamental to its ability to act in the public interest," stating that the ability to enforce cooperation from regulated persons is "'at the heart of the self-regulatory system for the securities industry.'" *Id.* at *40, *40 n.38 (quoting *Berger*, 2008 WL 4899010, *4).

In *Larry O'Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 (Oct. 19, 2010), the Board reviewed a hearing officer's initial decision that had imposed sanctions upon an auditor and his firm for noncooperation. O'Donnell, like Bassie, originally cooperated with a Board investigation by providing testimony, but thereafter he and the firm, of which he was sole principal, refused to respond to further requests for documents contained in two ABDs. *Id.* at 3-5. Respondents did not respond in any way to the resulting institution of proceedings against them, and the hearing officer found them in default and ordered sanctions. *Id.* at 5. On review, the Board found that respondents' failure to respond to the ABDs constituted noncooperation that warranted revocation of the registration of the firm and a permanent associational bar on O'Donnell, finding that "[r]espondents' noncooperation prevented the Board from being able to follow up adequately on indications of possible violations of law and PCAOB Rules" and that "[t]his type of noncooperation undermines the Board's ability to protect investors and advance the public interest, and indicates a lack of sufficient regard for Board processes and authority designed to do so." *Id.* at 7. The Board concluded that a civil money penalty of $75,000 against O'Donnell was appropriate, noting that this amount is "well below the maximum penalty that we could impose" but "reflects the seriousness of the noncooperation, including the harm to investors from the possibility that such noncooperation may have prevented the Board from uncovering evidence that would have revealed failures or violations warranting an even steeper penalty." *Id.* at 14.

In *Davis Accounting Group, P.C.*, PCAOB Rel. No. 105-2009-004 (Mar. 29, 2011), *pet. for review dismissed*, SEC Rel. No. 34-65581, 2011 WL 4954239 (Oct. 18, 2011), the Board found, on review of a decision by the hearing officer on summary disposition, that Edwin Davis and his firm failed to produce documents to the Division as requested in ABDs for more than 20 months, producing some documents only after the Board instituted proceedings against them for noncooperation. The Board found that respondents' conduct warranted revocation of the firm's registration and a permanent associational bar on Davis, noting that Davis acknowledged that he and his firm "made a choice" to "develop their business and issue audit reports" "rather than comply with regulatory requirements" and determining that "such noncooperation indicates a lack of sufficient regard for Board processes and authority designed by statute to protect investors." *Id.* at 15. The Board also imposed a $75,000 civil money penalty on Davis, noting the respondents' "disregard" of their obligation to comply with the Board's investigation, the "indirect harm to others" caused by their misconduct, and the "seriousness of the noncooperation." *Id.* at 19, 22.

As we explain below, Farhang's arguments do not persuade us that the Board lacks statutory authority to sanction him for refusing to testify, including through the imposition of a civil money penalty, or that doing so is contrary to the Constitution.

A. The Board's authority to sanction Farhang for noncooperation is not conditioned on his consent to cooperate.

Farhang argues that the Board's authority under Section 105(b)(3) to sanction persons for refusal to cooperate with a Board investigation is contingent upon a separate provision of the statute, Section 102(b)(3), 15 U.S.C. 7212(b)(3). Farhang claims that these two sections of the statute must be read together to mean that "[a]n auditor must provide an advanced written consent under Section 102(b)(3) before the Board even has the ostensible authority to impose a noncooperation sanction against the auditor under Section 105(b)(3)." R.D. 28 at 2-3. According to Farhang, he cannot be sanctioned for refusing to cooperate with any Board investigation because he never provided that consent to the Firm. Farhang's position is that the Board's authority to sanction an associated person for refusing to cooperate with an investigation is determined by the personal choice of that individual in providing or withholding the consent. In fact, the specific sanctioning authority provided by Section 105(b)(3) does not depend upon the associated person in question having provided such a consent.

Section 102(b), captioned *Applications for Registration*, governs the form and content of a public accounting firm's application for PCAOB registration. Section 102(b)(3) requires that each such application include the firm's "agreement to secure and enforce," and a statement that the firm understands and agrees that the continuing effectiveness of its registration is conditioned on "securing and enforcement of," consents from its associated persons, "as a condition of their continued employment by or other association with such firm," "to cooperation in and compliance with any request for testimony or the production of documents made by the Board in furtherance of its authority and responsibilities" under the Sarbanes-Oxley Act. By the plain terms of Section 102(b), a firm's failure to make those statements may have consequences for the firm's registration application, and a registered firm's failure to act in accordance with those statements may have consequences for the firm's registration status.

But the Sarbanes-Oxley Act does not suggest any connection between those firm registration provisions and the distinct and unqualified authority, in Section 105(b)(3), to impose sanctions on an associated person who refuses to testify in connection with a PCAOB investigation. If Congress had intended the law to be understood as Farhang urges, it would have been a simple matter for Congress to have made that clear by including a clause in Section 105(b)(3) so that, instead of encompassing "any associated person," it encompassed only "any associated person who has executed a consent described in Section 102(b)(3)(A)."[4] Even when Congress amended Section 2(a)(9) of the Sarbanes-Oxley Act to make clear that the sanctioning authority under Section 105(b)(3) encompassed a person's noncooperation relating to a period when that person was "seeking to become associated" or was "formerly associated" with the firm, Congress did not suggest that it mattered whether that person had already executed a consent described in Section 102(b)(3)(A). *See* Section 2(a)(9)(C)(ii)(II), as added to the Sarbanes-Oxley Act by Section 929F(g)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (July 10, 2010).[5]

Farhang concedes there is no statutory language explicitly stating that "consent [is] required as a condition of imposing discipline under Section 105(b)(3)," and he is left to argue that consent is an "implicit" condition. *E.g.*, R.D. 34 (Reply Brief (Reply Br.)) 2, 6. He argues that it must be a condition because he can discern no purpose for requiring firms to obtain consents from their employees except to give rise to the Board's jurisdiction to sanction persons for noncooperation, and thus he concludes that asking firms to obtain written consents would be "a meaningless formality" if his interpretation is wrong. R.D. 30 (Opening Brief (Br.)) 3. But the fact that Farhang cannot discern any other legislative purpose for Section 102(b)(3) that he would credit is not a persuasive argument that Section 105(b)(3) does not mean what it very precisely

[4] Farhang does not contend that the lack of a consent had any effect on whether he was an "associated person," and he does not dispute that he was an associated person as that term is used in Section 105(b)(3). A person is an associated person of a registered public accounting firm if, in connection with the preparation or issuance of any audit report, that person (i) shares in the profits of, or receives compensation in any other form from, a registered public accounting firm; or (ii) participates as agent or otherwise on behalf of such an accounting firm in any activity of that firm. Sarbanes-Oxley Act Section 2(a)(9)(A), 15 U.S.C. 7201(a)(9)(A); PCAOB Rule 1001(p)(i).

[5] Although not directly relevant to the application of Section 105(b)(3), we note that associated persons of members of a registered securities association, such as FINRA, (as that category of persons is defined in Section 3(a)(21) of the Securities Exchange Act of 1934) (Exchange Act) are expected to have executed a securities industry Form U-4, which includes among other things their consent to "submit to the authority of the jurisdictions and SROs and agree to comply with all provisions, conditions and covenants of the statutes, constitutions, certificates of incorporation, by-laws and rules and regulations of the jurisdictions and SROs" and to "comply with all requirements, rulings, orders, directives and decisions of, and penalties, prohibitions and limitations imposed by the jurisdictions and SROs," but there is no suggestion in the Exchange Act, or in any Commission or court decisions of which we are aware, that the registered securities association's authority to sanction a person who meets the definition in Section 3(a)(21) depends upon that person having actually provided such a consent.

says. Moreover, it is not difficult to identify useful purposes that Farhang apparently overlooks. For example, he fails to appreciate that conditioning a firm's registration on a manifestation of the firm's direct involvement in fostering its associated persons' awareness of both the possibility of being called upon to cooperate in the Board's processes and the potentially severe consequences of failing to do so, has value wholly unrelated to the Board's jurisdiction to sanction the firm and its associated persons.

In addition to being at odds with the plain language of Section 105(b)(3), Farhang's argument posits no rationale for why Congress would have meant for associated persons to avoid the possibility of Section 105(b)(3) sanctions just because they declined to provide a consent and they worked for a registered firm that failed to secure and enforce such consents. Instead of suggesting any such rationale, Farhang essentially argues that it would not have occurred to Congress that such a situation might arise, and therefore Congress cannot have intended that Section 105(b)(3) would address it. Specifically, Farhang contends that, given the specter of job loss, "it would be natural" for Congress to "*assume* and presuppose" that every associated person would execute a consent before they could ever be in a position to refuse to cooperate with the Board. Reply Br. 6 (emphasis in original). Farhang then reasons that "having naturally assumed" that all necessary consents would be provided, Congress would have had no reason to address situations in which consents were not provided. *Id.* But this does not explain why Congress would have put the Board's sanctioning authority for noncooperation at the mercy of such speculative presupposition and assumption, which would essentially exempt any person from discipline for failure to cooperate who, by design or otherwise, actually subjected themselves to the risks Farhang describes.[6/]

A firm's failure to secure and enforce consents from its associated persons does not immunize those associated persons from sanctions for noncooperation. The

[6/] To further illustrate that Farhang's position has consequences Congress would not have intended, we note that presumably he takes the view that the Board could sanction a person for noncooperation, under the Sarbanes-Oxley Act as amended in July 2010, who tendered a consent when a firm applied for PCAOB registration, even if the person briefly was seeking to but ultimately did not become associated with the firm, yet the Board could not reach a person who became associated with the firm at some later date and functioned in that capacity for a long period of time if the firm neglected to secure a consent from that person. Just as we have noted that a registered firm would be subject to sanctions if it did not cooperate and comply with Board requests even if the firm had not provided a consent that it would do so, *see Policy Statement Regarding Credit for Extraordinary Cooperation in Connection with Board Investigations*, PCAOB Rel. No. 2013-003, at 2 n.3 (Apr. 24, 2013), an associated person is subject to sanctions if he or she does not cooperate and comply even if he or she has not signed a consent to do so.

Board's authority to sanction associated persons for refusing to cooperate with an investigation flows sensibly, directly, and unimpededly from Section 105(b)(3).

B. Imposing Sanctions for Farhang's Refusal To Testify Does not Violate the Constitution.

Farhang also challenges on constitutional grounds the Board's authority to impose sanctions for his refusal to testify. His arguments attempt to weave together various constitutional threads. He asserts, with apparent reference to Section 102(b)(3), that because the Sarbanes-Oxley Act "conditions [his] initial and continued employment on the requirement that he subject himself to severely diluted due process (that fails to pass constitutional muster) under an unconstitutionally vague and amorphous standard," on pain of sanctions, that this "prior written consent requirement" is invalid under "the doctrine of unconstitutional conditions." Br. 6-7; Reply Br. 8. Farhang's "unconstitutional conditions" argument has no force in this case for at least three reasons. First, it is directed at Section 102(b)(3). As we have just determined, Section 105(b)(3) authorizes sanctions against him without regard to whether he executed consent as described in Section 102(b)(3). He is not being sanctioned for failing to execute a consent; he is being sanctioned for refusing to testify. Further, the "vagueness" and "due process" components of his argument are meritless.

As to vagueness, Farhang asserts broadly that "noncooperation" is an "constitutionally vague, amorphous, and ill-defined standard" against which to measure his conduct. Reply Br. 9; R.D. 22a at 13. The relevant statutory language here, though, in a case in which Farhang admits that he refused to testify in connection with an investigation, is the language authorizing the Board to impose sanctions if an associated person "refuses to testify…in connection with an investigation." Understandably, his briefing is devoid of any contention that this specific language is vague. Plainly, it is not vague, and it is all that is necessary to resolve this case.

Regarding the due process component of his "unconstitutional conditions" argument, Farhang asserts that he "has a constitutionally protected due process right," of which he would be deprived if he could be sanctioned for refusing to testify in the Board's investigation, "to be free from investigative procedures of a governmental actor, or resulting disciplinary proceedings, that deprive him of full and undiluted due process rights commensurate with those in federal court." Reply Br. 8. He claims the Board's procedures "fail to provide [a] sufficient level of due process commensurate with the potential penalties (akin to criminal penalties) that the Board may impose on an associated person for noncooperation." *Id.* at 10.

Farhang's amorphous, unfocused attack on the Board's investigatory and adjudicatory procedures implies that all of these rules fail because they do not comport with the high level of procedural due process assigned to criminal judicial proceedings. As an initial matter, Farhang has made no showing that Board authority to impose a civil money penalty for refusing to testify is "so punitive in either purpose or effect...as to transform what was clearly intended as a civil remedy into a criminal penalty" such that some elevated level of due process is necessary. *See generally Hudson v. United States*, 522 U.S. 93, 99 (1997); *Hogan & Hartson v. Butowsky*, 459 F. Supp. 796, 799 (S.D.N.Y. Oct. 24, 1978) ("a more stringent standard of due process must be adhered to in criminal matters than in purely civil matters"); *Gary M. Kornman*, SEC Rel. No. 34-59403, 2009 WL 367635, *12-*13 (Feb. 13, 2009) (in rejecting double jeopardy argument, explaining that broker-dealer and investment adviser bars are civil, not criminal sanctions). Further, he ignores the established principle that the constitutional requirements of procedural due process do not demand that administrative agencies adopt "judicial-type procedures." *Mathews v. Eldridge*, 424 U.S. 319, 348 (1976) ("[D]ifferences in the origin and function of administrative agencies 'preclude wholesale transplantation of the rules of procedure, trial, and review which have evolved from the history and experience of courts.") (quoting *FCC v. Pottsville Broadcasting Co.*, 309 U.S. 134, 143, (1940)). He also ignores the distinction between the investigative and adjudicative stages of a proceeding, a distinction that is critical to identifying the procedural due process protections that apply in each context. *United States v. Steel*, 238 F. Supp. 575, 577 (S.D.N.Y. 1965) ("[W]hen a government agency is conducting an investigation, as here, in contrast to making an adjudication, 'due process' does not require granting to those being investigated 'rights...normally associated only with adjudicatory proceedings.'") (quoting *Hannah v. Larche*, 363 U.S. 420, 442 (1960)); *Kevin Hall, CPA*, SEC Rel. No. 34-61162, 2009 SEC LEXIS 4165 at *73 (Dec. 14, 2009) (distinguishing adjudicative from investigative processes in the application of due process principles) (quoting *Friedman v. Rogers*, 440 U.S. 1, 18 (1979) and citing *SEC v. O'Brien*, 467 U.S. 735, 742 (1985) and *Hannah*, 363 U.S. at 440-43).

The Board's rules establish "fair procedures" for investigating and disciplining associated persons, as required by Sarbanes-Oxley Act Section 105(a), 15 U.S.C. 7215(a), and those rules comport with the due process requirements applicable to each function. At the investigative stage, PCAOB rules require Board authorization to initiate a formal investigation (Rule 5101); establish terms for participation of a witness's counsel in an investigative examination (Rule 5109(b)); and preserve the right to validly assert privileges, including that against self-incrimination (Rule 5106; *see* PCAOB Rel. No. 2003-015 at A2-33 (Sept. 29, 2003).[7/]

[7/] Farhang does not assert that his refusal to testify in this matter was based on the Fifth Amendment protection against self-incrimination or any other privilege. Indeed, for example, simply issuing a blanket refusal to testify, as Farhang did, does not properly invoke the Fifth Amendment. *See Burke v. Bd. of Governors of Fed. Res. Sys.*, 940

At the adjudicatory stage, PCAOB rules require Board authorization of an order instituting proceedings for noncooperation (Rule 5110); permit representation by counsel in the proceedings (Rule 5401(b)); permit a respondent to inspect and copy the documents upon which the Division intends to rely for a finding of noncooperation (Rule 5422(a)(2)); provide for an adversarial hearing before a disinterested hearing officer to develop relevant evidence and provide the respondent with a full and fair opportunity to present his defenses (Rules 5200, 5440-45); and provide for *de novo* review of the initial decision by the Board on petition by a party or on the Board's own initiative (Rule 5460), among other things. These PCAOB rules operate on the premise that any imposition of sanctions by the Board is then subject to multiple layers of appellate review, by the SEC and the federal courts. *See* 15 U.S.C. 7217(c); 15 U.S.C. 78y(a).

These rules, which have been approved by the Commission (*Order Approving Proposed Rules Relating to Investigations and Adjudications*, SEC Rel. No. 34-49704 (May 14, 2004)), provide ample process for firms and individuals subject to Board discipline. Farhang—who during these proceedings has been represented by counsel, obtained the setting aside of the default, received documents from the Division, asserted affirmative defenses, availed himself of the summary disposition process, and submitted materials to the hearing officer that were considered in the initial decision, and appealed the initial decision to the Board—has identified no denial of due process.

For all of these reasons, Farhang's "unconstitutional conditions" argument is no impediment to the imposition of sanctions in this case.[8/]

F.2d 1360, 1367 (10th Cir. 1991); *United States v. Malnik,* 489 F.2d 682, 685 (5th Cir. 1974) (collecting cases), *cert. denied,* 419 U.S. 826.

[8/] To the extent Farhang claims (*see* Reply Br. 8-9), as part of or in addition to his "unconstitutional conditions" argument, that sanctioning him for refusing to testify violates his "constitutionally protected due process rights" for some other reason than supposed defects in the Board's investigatory or disciplinary procedures or that the Constitution somehow limits the application of the Section 105(b)(3) authority only to persons who had executed a consent to cooperate with the Board, he provides no elaboration or support for any such propositions, and we see no valid basis for them. Because Farhang has not established that sanctioning him for refusing to testify impinges on any constitutionally protected interest, we need not reach his claim that, in sanctioning him, the Board must have a "compelling governmental interest," achieved through the "least restrictive means." Br. 7; Reply Br. 10-11. We do note, however, that Farhang's argument is based on an inapposite case involving government regulation of constitutionally protected speech. *See* Reply Br. 10 (citing only *Sable Communications of California, Inc. v. FCC*, 492 U.S. 115 (1989), a First Amendment case).

C. Civil penalties are appropriately available as a category of sanctions for noncooperation under the Sarbanes-Oxley Act.

Sarbanes-Oxley Act Section 105(b)(3) provides, as pertinent here, that if "a registered public accounting firm or any associated person thereof refuses to testify…in connection with an investigation under this section, the Board may…suspend or bar such person from being associated…[and] invoke such other lesser sanctions as the Board considers appropriate, and as specified by rule of the Board." Farhang argues that "[t]he words 'lesser sanctions' must be given meaning" and that the only way to do so is to adopt his view that "[w]hether the amount of a civil money penalty constitutes a 'lesser sanction' (than a permanent bar) and would be statutorily permitted necessarily turns on the unique and specific facts of each case." Br. 8. By contrast, the Board considered in implementing Section 105(b)(3) through rulemaking, and codified in its rules, what types of sanctions are legally available in noncooperation cases generally and then in each case in which it imposes sanctions, the Board separately determines from among the legally available sanctions the specific sanctions, whether non-monetary, monetary, or both, that are appropriate under the particular facts and circumstances. The language "lesser sanctions" has thus already been given a meaning—one implemented by the Board and approved by the SEC—and, for good reason, that meaning does not involve the approach Farhang urges.

Soon after the Board was created, it interpreted Section 105(b)(3)'s reference to "lesser sanctions" as including civil money penalties. That interpretation is reflected in a public rulemaking process that culminated in SEC approval of PCAOB Rule 5300(b), which includes civil money penalties among sanctions available for noncooperation with investigations. Not unlike Farhang, a commenter on the Board's proposal of Rule 5300(b) "expressed doubt that the [Sarbanes-Oxley] Act authorizes the imposition of money penalties for noncooperation," PCAOB Rel. No. 2003-015 at A2-77 (Sept. 29, 2003). In adopting Rule 5300(b), the Board disagreed with that comment, noting that "[w]e believe that an appropriately calibrated money penalty is a 'lesser sanction' than revocation of a firm's registration or a bar on association with a firm." *Id.* In accordance with Section 107 of the Sarbanes-Oxley Act, 15 U.S.C. 7217, and Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b), the SEC approved Rule 5300(b) on May 14, 2004, determining that the rule was "consistent with the requirements of the [Sarbanes-Oxley] Act and the securities laws" and was "necessary and appropriate in the public interest and for the protection of investors." SEC Rel. No. 34-49704, 2004 WL 1439833. As described earlier, the Board has since imposed civil money penalties for noncooperation with investigations, and the SEC, in the *Bassie* case, has sustained such penalties.

The interpretation reflected in PCAOB Rule 5300(b)(1) is eminently reasonable. *Cf. Gonzalez v. Reno,* 212 F.3d 1338, 1351 (11th Cir. 2000) (accepting interpretation where it “comes within the range of reasonable choices” in interpreting statutory text). Congress generally gave the Board broad authority to impose “[a] full range of sanctions,” including “substantial civil money penalties,” if the Board finds that a registered firm or its partners or employees has “violated one or more of the rules within the Board’s investigative jurisdiction.” S. Rep. No. 107-205 at 11 (2002). The interpretation of Section 105(b)(3) as permitting the Board to identify civil money penalties as among the available categories of sanctions that, by nature, do not rise to the level of permanent or temporary removals from the practice of auditing public companies and broker-dealers is consistent with that broad authority.

More specifically, that interpretation is also consistent with the structure of Sarbanes-Oxley Act Section 105(c)(4), 15 U.S.C. 7215(c)(4), which sets out types of sanctions for violations of the Sarbanes-Oxley Act and Board rules and standards in more detail than the three types of sanctions listed in Section 105(b)(3), with civil money penalties listed below revocation/suspension of registration, bar/suspension from association, and limitation on activities, but above censure and additional professional education. A suspension or revocation of the registration of a firm in the securities industry, or a suspension or bar of an individual from associating with such a firm, can have a significant impact that, in terms of the damage to professional reputation and loss of gainful employment in the industry, exceeds a one-time civil money penalty. *Cf. PAZ Secs., Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007) (generally describing “expelling a member from the NASD or barring an individual from associating with an NASD member firm” as “the securities industry equivalent of capital punishment”) (citing *Steadman v. SEC*, 603 F.2d 1126, 1137-40 (5th Cir. 1979) (describing expulsion and associational bar as “the most drastic remedies at [the Commission’s] disposal”), *aff’d on other grounds,* 450 U.S. 91 (1981)); *see also Kornman v. SEC,* 592 F.3d 173, 188 (D.C. Cir. 2010) (referring to a sanction other than permanent bar as a “lesser sanction”). It is reasonable to conclude that the most significant sanction authority granted the Board under the Sarbanes-Oxley Act is the power to deny an associated person or firm the ability to conduct audits of issuers or broker-dealers. Farhang essentially concedes this, claiming that a permanent bar “will ruin his career, livelihood, and ability to earn anything meaningful” without explaining how a one-time $75,000 penalty would be worse than this. Reply Br. 11.

Additionally, the interpretation reflected in PCAOB Rule 5300(b) is consistent with the approach of FINRA, whose rules and practice the Commission has considered in reviewing PCAOB disciplinary action. *See S.W. Hatfield, CPA,* SEC Rel. No. 34-69930, 2013 SEC LEXIS 1954, *4-*5, *89*-*97 (July 3, 2013); *Bassie*, 2012 SEC LEXIS 89, *40. Indeed, based on statutory authority that is no more specific on the money penalty point than is Section 105(b)(3),[9/] the Commission has regularly upheld money penalties imposed by registered securities associations on associated persons of their members for failing to provide requested information. *See Robert Marcus Lane*, SEC Rel. No. 34-74269, 2015 WL 627346, *1, *21-*22 (Feb. 13, 2015) (sustaining $25,000 fine and two-year suspension imposed on individual who failed to timely respond to FINRA information request); *CMG Inst'l Trading, LLC*, SEC Rel. No. 34-59325, 2009 WL 223617, *1, *8-*10 (Jan. 30, 2009) (sustaining $25,000 joint and several fine and two-year suspension imposed on firm and individual that failed to completely respond to NASD information request).[10/]

Farhang counters by loosely and incorrectly characterizing the PCAOB as "essentially a federal agency that need not comply with federal salary caps" and then asserting that he is "unaware of any federal agency that has the power to impose civil money penalties for 'noncooperation.'" Br. 4. But if federal agencies' organic statutes do not provide authority identical to what Congress provided to the Board in Section 105(b)(3), that does not mean that Congress did not provide it to the Board. Moreover, Farhang's argument overlooks the fact that, unlike the Board, it is common for federal agencies to have direct access to the courts to enforce compliance with administrative

[9/] In the case of a registered securities association, such as FINRA, the relevant statutory authority includes Section 15A(g)(3)(C) of the Exchange Act, 15 U.S.C. 78*o*-3(g)(3)(C), ("registered securities association may bar any person from becoming associated with a member if such person does not agree: (i) to supply the association with such information with respect to its relationship and dealings with the member as may be specified in the rules of the association") and Section 15A(h) of that Act, 15 U.S.C. 78o-3(h), (registered securities association may impose disciplinary sanctions against "a person associated with a member" for violations of a rule of the association).

[10/] Farhang notes the fact that the SEC has authority, under Exchange Act Section 21(e), 15 U.S.C. 78u(e), to seek through the courts to enforce PCAOB money penalties that the Commission has affirmed. Br. 4-5; Reply Br. 4 n.10 (misidentifying the statutory provision as 15 U.S.C. 78u(d)(3)(A)). Farhang argues that this is a difference between PCAOB money penalties and FINRA money penalties that renders FINRA's practice irrelevant to the issue here. In fact, however, the authority provided to the Commission by Section 21(e) encompasses money penalties imposed by a registered securities association, which FINRA is, to the same extent that it encompasses PCAOB money penalties. Furthermore, logically, a view that PCAOB civil money penalties, which "can be enforced through the federal court system" (Br. 5), would be more meaningful and effective in addressing noncooperation than FINRA fines, mischaracterized as a "paper tiger of no consequence in court" (*id.*), does not mean that PCAOB money penalties would be invalid but instead could bolster the very reasonableness of imposing them.

subpoenas that those agencies may issue and that it is then the court's province to enforce noncompliance with a judicial order. *See, e.g., Bassie*, 2012 SEC LEXIS 89, *46 n.47; 7 Op. O.L.C. 131 (1983) (discussing the myriad agencies that have subpoena power, explaining the general rule that, "[w]hen an individual refuses to comply with a subpoena, an agency must go to court, represented either by agency lawyers or by the Attorney General, to have it enforced," and describing how the court then presides over a process for determining if the respondent "should be held in contempt for failure to obey the court order"). Sanctions sought in a contempt proceeding can include monetary fines in significant amounts. *See, e.g., SEC v. Yuen*, SEC Lit. Rel. No. 18095, 2003 WL 1900835 (Apr. 18, 2003) (noting filing of civil contempt application in federal district court for failing to appear to testify per subpoena and requesting that the court hold respondent in contempt, order him incarcerated, and impose a daily civil fine of $50,000, doubling daily, until he purges his contempt by appearing for testimony).

Having appropriately implemented the authority given by Section 105(b)(3) in promulgating Rule 5300(b)(1), the Board applies that rule to the facts and circumstances presented in each case to determine which of the specified legally available sanctions are appropriate in that case to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports. *See* Sarbanes-Oxley Act Section 101(a); *see also* Section 101(c)(5), 15 U.S.C. 7211(c)(5). That involves quintessentially a conclusion about "the relation of remedy to policy," which is "peculiarly a matter" for the body authorized by law to impose the sanctions to decide. *Cf. American Power & Light*, 329 U.S. 90, 112 (1946); *Tager v. SEC*, 344 F.2d 5, 8-9 (2d Cir. 1965); *County Produce, Inc. v. U.S. Dept. of Agriculture*, 103 F.3d 263, 266-67 (2d Cir. 1997); *Niagara Mohawk Power Corp. v. FPC*, 379 F.2d 153, 159 (D.C. Cir. 1967) ("the breadth of agency discretion is, if anything, at zenith when the action assailed relates primarily…to the fashioning of policies, remedies, and sanctions").

Farhang offers no authority or reasoning that would compel the adoption of his alternative position that the Board is required to determine whether a civil money penalty is a legally available sanction under Sarbanes-Oxley Act Section 105(b)(3) as a threshold issue on a case-by-case basis. Farhang's position would require consideration of whether the amount of a particular civil penalty is sufficiently great (by some undefined measure) compared to a revocation, bar, or suspension, in the context of all of the facts and circumstances of each individual case and each respondent's personal situation, as to render it wholly unavailable as a sanction. That position would require the statute to be re-interpreted anew with each case and impose a nebulous, difficult-to-administer construct for determining a threshold question of legal authority.

In sum, Farhang has not identified any defect in the Board's rules or processes as a general matter, nor any defect in the proceeding against him specifically, that would prevent the Board from imposing sanctions available under Sarbanes-Oxley Act Section 105(b)(3) as implemented by PCAOB Rule 5300. We now turn to a determination of the sanctions appropriate in this case.

VI.

In determining appropriate sanctions in a particular case, we consider the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, to discharge our statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports. *See* Sarbanes-Oxley Act Section 101(a); *see also* Section 101(c)(5) (in identifying duties of the Board, referring to objective "to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof" or "otherwise to carry out this Act, in order to protect investors, or to further the public interest"); *Gately & Associates, LLC*, SEC Rel. No. 62656, 2010 SEC LEXIS 2535, *50 n.52 (Aug. 5, 2010) ("the appropriate sanctions in any case depend on the particular facts and circumstances presented rather than on a comparison with other cases involving different circumstances"). Farhang makes no argument that, if the Board has the legal authority to sanction him for his refusal to cooperate with the investigation, a censure and associational bar would be unwarranted, only that a civil money penalty would be inappropriate. *See, e.g.,* Reply Br. 11.

A refusal to cooperate with a Board investigation is serious misconduct warranting strong sanctions. As discussed above, "investigations play a crucial role in furthering the Board's goals of investor protection and the preparation of informative, accurate, and independent audit reports," and "[t]he Board's power to impose appropriate sanctions in disciplinary proceedings is fundamental to its ability to act in the public interest." *Bassie*, 2012 SEC LEXIS 89, *40 (citing *Howard Brett Berger*, SEC Rel. No. 34-58950, 2008 WL 4899010, *4 (Nov. 14, 2008)).

Farhang was well-situated to provide potentially valuable information, given his involvement as audit manager for the audit under investigation. Farhang initially agreed to comply with the June 30, 2015 ABD. After he later reversed course, one of his stated reasons was that he had "more important financial obligations" than those associated with testifying. This indicates that he is not willing or able to manage both his regulatory responsibilities and his personal obligations. Farhang's refusal to cooperate with the investigation came suddenly after the revelation, with his counsel present, of information suggesting possible misconduct on Farhang's part in connection with the Issuer A audit. And Farhang repeatedly refused to testify even after the Division reminded him he could represent himself and offered to minimize the expense and inconvenience of testifying by covering reasonable expenses related to appearing, or conducting the testimony in Los Angeles or at another location convenient to him. This raises the concern that his noncooperation was designed to avoid responsibility for possible misconduct. Only long after receiving the ABD and initially providing certain documents and agreeing to testify did Farhang, represented by the same counsel, make any reference to legal objections to complying with Board requests for information, and Farhang declined at that time to engage with the Division in any detail about the substance of his objections. Even as to the documents he had provided, his refusal to testify deprived the PCAOB investigators of any opportunity to examine him about those materials and their relation to other documents or testimony, and to determine whether they truly comprise the total universe of relevant information in his possession.

Farhang's refusal to testify "frustrate[d] the oversight system envisioned by Sarbanes-Oxley, impeding the Board's ability to discover violations." *Bassie,* 2012 SEC LEXIS 89, *40. Moreover, his deliberate choice to avoid testifying displayed little or no regard for the Board's processes and, by extension, for its public-interest mandate. Farhang has given no indication, at least since refusing to testify, that he recognizes the importance of cooperation to the Board's mandate. *See generally Gale Moore, CPA*, PCAOB File No. 105-2012-004, at 49 (Aug. 23, 2016) (citing cases discussing lack of appreciation of regulatory responsibilities and lack of recognition of the wrongful nature of conduct as supporting imposition of associational bar). Furthermore, although Farhang has asserted that he "left the practice of auditing public companies" in 2015, there would be no impediment, absent Board sanctions, to his returning to that practice and, indeed, doing so would appear to be attractive, as Farhang states that he earned a higher income while engaged in the practice of auditing public companies. R.D. 22a at 20. Under these circumstances, we conclude that a permanent bar is appropriate to prevent Farhang from undermining Board processes in the future and jeopardizing the protection for investors that those processes provide. *Bassie*, 2012 SEC LEXIS 89, *42; *O'Donnell*, PCAOB File No. 105-2010-002 at 7-8 (Oct. 19, 2010).

We also conclude that a civil money penalty is warranted to impress upon Farhang and others the seriousness of choosing not to cooperate with a Board investigation, as well as to address the harm inherent in such conduct, to the Board's ability to carry out its investigation and to investors deprived of important protection they should have had under the Sarbanes-Oxley Act. Arguing for mitigation, Farhang has observed that, unlike the individual respondents in the three prior litigated PCAOB noncooperation cases in which $75,000 penalties were assessed—*Bassie, O'Donnell,* and *Davis*—he was not a controlling partner of a co-respondent firm, and thus his actions were not attributable to any firm and did not translate into equivalent noncooperation by a firm. R.D. 24 at 2. Farhang has also implied that he earned little or no fees from issuer audits after the date on which he refused to testify. *Id.* at 3. We accord these factors some weight in the analysis. It bears noting, however, that even on their own terms, these arguments do not exclude the possibility that Farhang's refusal to testify still impeded the Firm's cooperation, they do not lessen Farhang's own responsibility to cooperate, and they do not suggest, particularly in light of the points made earlier in this section, that he was unable to provide any, or any more, distinctive and important information in his own right. Nor do they necessarily mean that Farhang did not collect, or seek to collect, some fees from auditing issuers after refusing to testify in September 2015. Indeed, Farhang has stated that "[f]or the 2015 calendar year," he collected over $70,000 from "audit and review work part-time for three issuers" and "in 2015" he "left the practice of auditing public companies," without ever specifying when in 2015 these occurred. R.D. 22a at 20-21.

As we have made clear, refusals to cooperate with investigations can appropriately be sanctioned with civil money penalties because such refusals cause at least indirect harm to investors that it may never be possible to quantify and thwart our ability to identify and rectify violations of statutes, rules, and standards we are charged with enforcing. *See Davis,* PCAOB File No. 105-2009-004 at 19 ("Investors and markets are put at risk, and perhaps harmed in ways that never become known, when a regulatory investigation is improperly thwarted by a regulated person's refusal to provide information."). The Commission has found civil penalties appropriate regardless of whether unjust enrichment resulted from the misconduct or there was a finding of a history of prior misconduct. *Bassie*, 2012 SEC LEXIS 89, *46 & n.46 (citing *PHLO Corp.*, SEC Rel. No. 34-55562, 2007 WL 966943, *15 n.84 (Mar. 30, 2007) (imposing civil penalty in absence of unjust enrichment or disciplinary history)). And properly calibrated civil money penalties appropriately provide deterrence, which is necessary given the facts here. *See id*. at *51-*52 ("While imposing a larger penalty in this case might provide an even greater deterrent against similar stalling by other registered public accounting firms and their associated persons, a civil penalty of $75,000 appears sufficient to have a deterrent effect on a firm such as Bassie's.").

We have previously described our approach to consideration of imposing civil money penalties under Sarbanes-Oxley Act Section 105(b)(3) and PCAOB Rule 5300(b)(1). *See, e.g., Bassie*, PCAOB Rel. No. 105-2009-001 at 13-15, 19; *Davis,* PCAOB File No. 105-2009-004 at 16-19, 21; *O'Donnell,* PCAOB File No. 105-2010-002 at 8-11, 14. Applying that approach in this case, in light of the above-described conduct and considerations of harm and need for deterrence, as well as the points described above that Farhang raised in an effort to distinguish our prior adjudications imposing a $75,000 civil penalty for the fundamentally serious misconduct of noncooperation with a PCAOB investigation, we have determined that a $50,000 civil penalty is appropriate under the circumstances. While this is well below the maximum civil money penalty we could impose under Rule 5300(b)(1), it nonetheless reflects the seriousness of Farhang's refusal to testify, including the harm to investors from the possibility that such conduct may have prevented the Board from uncovering evidence that would have revealed failures or violations warranting an even steeper civil money penalty, and is sufficient to deter similar noncooperation by others. Overall, we conclude that the sanctions we impose in this case are sufficient to protect investors and further the significant public interest at stake without being in any way excessive or oppressive.

VII.

We now address Farhang's assertions that in determining whether to impose a civil money penalty in this case, "[t]he Board must consider Respondent's 'ability to pay,' and [that] Respondent has proven that he has no ability to pay." Reply Br. 12 n.14. Neither assertion is correct, as we explain below.

As background, in a telephone conference on March 9, 2016, the hearing officer raised on his own the question whether, "if a Respondent in a PCAOB proceeding is unable to pay a penalty amount," then "should [that amount] be waived?" R.D. 16b at 5. The Division responded that it "disagree[d] as a general proposition [and], in particular, disagree[d] in this context of a non-cooperation proceeding." *Id.* The hearing officer, in a March 11, 2016 order setting a schedule for filing cross-motions for summary disposition, directed Farhang to "promptly provide to the Division copies of Respondent's 2015 and 2014 federal income tax returns, as well as a sworn financial statement detailing all of Respondent's assets and liabilities." R.D. 18 at 2.

On March 31, 2016, pursuant to that order, the Division filed a statement of position explaining that it had reviewed the financial information Farhang submitted and did not believe that the information established an inability to pay a civil money penalty. R.D. 20 at 1. Among other things, the Division noted that the information disclosed that Farhang managed his income and expenses through an S corporation, which reported income in 2014 and 2015 of $119,200 and $83,306, respectively—significantly higher than the adjusted gross income amounts of $51,864 and $39,800 for those years that he had earlier represented he made. *Id.* at 2. The Division also stated that many of the expenses he disclosed "appear[ed] to be highly discretionary in nature," such as owning a 2014 Prius while also leasing a 2014 BMW 528i for $10,000 a year, and pointed out that between late 2014 and early 2016, Farhang's reported cash on hand had shrunk from $146,771 to $12,855 and it was "unclear where the money went." *Id*. The Division concluded that, although "[i]t would be difficult…to make a more detailed evaluation of Respondent's ability to pay a civil money penalty without a hearing and an opportunity to fully examine Respondent with respect to the financial information he has presented," the Division "[n]evertheless…believes that this financial information, on its face, demonstrates that Respondent has the ability to pay a substantial civil money penalty." *Id*. at 2-3. In its summary disposition motion papers, the Division reiterated its position that as a legal matter inability to pay is "'irrelevant' in cases involving an individual's egregious noncooperation" and that, if the hearing officer were to deem it relevant, an evidentiary hearing should be held on the issue. R.D. 23a at 24-25, n.108.

Farhang contended in his summary disposition motion papers, to which he attached the financial information, that he had "no current ability to pay" the $75,000 penalty the Division sought but "only a small civil money penalty." R.D. 22a at 19-21, n.22. He stated that he had risen to the level of a non-equity partner about two years before leaving the Firm at the end of 2014 and had supported himself in 2015 doing part-time work at another issuer audit firm and as an outside consultant to private clients and a bookkeeper. *Id.* at 20; R.D. 22b at 3; R.D. 24 at 2. But he emphasized on the basis of two months of data in 2016 that, in transitioning, at age 56, to "try[ing] to earn a living consulting, bookkeeping, and providing other accounting services to private clients" on a full-time basis, he had made what he regards as "almost nonexistent" income (Br. 9 n.4). R.D. 22a at 20-21. He made no reference to pursuing any other form of gainful employment. Without specificity or substantiation, he asserted that his draw-down of most of the large cash account over the prior two years was used "to cover his expenses in the face of declining revenues." *Id.* at 20 n.23. He represented that he pays alimony and child support, referred to the general difficulty attendant to living in expensive southern California, and claimed that his personal savings, less the funds in retirement accounts, amount to less than the penalty sought. R.D. 22b at 3-5.

In the initial decision, the hearing officer determined to impose a $75,000 civil money penalty, finding the sanction was "appropriate" and reflected "the seriousness of noncooperation, including the harm to the public when noncooperation prevents the Division from uncovering possible evidence of violative conduct." I.D. 19. But the hearing officer also stated that Farhang had shown "by a preponderance of the evidence" that "he has limited financial resources and no current prospects of earning more than a minimal income, particularly since this Initial Decision bars Farhang from association with a registered public accounting firm." I.D. 21. Ultimately, despite ordering Farhang to pay a civil penalty, the initial decision declared that "such payment will be waived based on Farhang's demonstrated inability to pay a civil penalty." I.D. 22.

Before us, Farhang takes the position that if we disagree with his other arguments about a civil money penalty in this case, we should "waive" payment of a civil penalty, referencing the initial decision's discussion of inability to pay. Reply Br. 12 n.14. The initial decision's discussion is not an adequate basis of decision here, and, despite the direction in our briefing order that the parties address inability to pay issues, Farhang's briefing contains only a cursory discussion of the subject.

As the Commission noted in *Bassie*, the Sarbanes-Oxley Act "does not recognize ability to pay as a factor to consider in determining whether to impose a civil money penalty." 2012 SEC LEXIS 89, *52 n.53. To the extent Farhang contends that the

PCAOB is compelled to consider inability to pay in imposing monetary sanctions, he cites no support for that proposition.[11/]

Further, as we stated in *Bassie,* "even if we were guided by the Exchange Act section 21B(d) approach," applicable to SEC administrative proceedings, with regard to ability to pay, "that approach commits to the agency's discretion the question of whether ability to pay is relevant to penalty considerations in any particular case." PCAOB Rel. No. 105-2009-001 at 18. We then stated that, even in the exercise of such discretion, "evidence concerning Respondents' ability to pay a penalty would be irrelevant to our determination of whether to impose a penalty" because of "the egregiousness of Respondents' noncooperation[] and the need to protect investors and advance the public interest by deterring such noncooperation." *Id*. The Commission agreed. 2012 SEC LEXIS 89, *52 n.53 (citing *Thomas C. Bridge*, SEC Rel. No. 34-60736, 2009 WL 3100582, *25 (Sept. 29, 2009) ("when conduct is 'sufficiently egregious,' the Commission may impose a sanction despite a demonstrated inability to pay"), *petition*

[11/] In his opening brief, filed on October 31, 2016, Farhang asserted without citation to authority that inability to pay "is a factor that is considered in determining civil money penalties by the EPA, FDA, OCC, FCC, FAA, FTC, FDIC, HUD, CFPB, DHHS, and also, importantly, and very recently, by the SEC (before ALJ Carol Fox Foelak)." Br. 9. In a footnote, Farhang's counsel represented that he "will be filing a statement of authority with supporting citations within the next week." Br. 9 n.3. One month later, on the afternoon the Division's responsive brief was due, Farhang's counsel filed an "Addendum of Citations in Further Support of Respondent's Opening Brief," consisting of a list of citations and parenthetical descriptions purportedly supporting the assertion in his opening brief about consideration of inability to pay by various federal agencies. R.D. 31. This submission was filed after his opening brief and without leave (and without seeking leave) from the Board. *See* Board Rule 5462(a) (stating that, "[u]nless otherwise provided, opening briefs shall be filed within 40 days of the date of the briefing schedule order," that "exceptions to the findings or conclusions being reviewed…shall be supported by…concise argument including citation of such statutes, decisions and other authorities as may be relevant," and that "[n]o briefs in addition to those specified in the briefing schedule order may be filed except with leave of the Board"). We therefore reject it as untimely. But, in any event, the submission makes no attempt to establish the relevance of the citations to the particular statutory regime under which the PCAOB operates or to the context of noncooperation with an investigation, nor is such relevance apparent. Farhang's assertion that "virtually every federal administrative agency (even the SEC post-*Bassie*) looks at a party's inability to pay when calculating civil money penalties" (Reply Br. 12) is not only divorced from any context but, on its face, concedes that this is not necessarily a universal practice even among agencies ("virtually every").

denied sub nom., *Robles v. SEC*, 2010 WL 5479603 (D.C. Cir. Dec. 30, 2010)). The same analysis would apply here, given Farhang's conduct, discussed above.

The initial decision acknowledged all of the above-described, on-point authority, and found that imposition of a substantial civil penalty was appropriate in this case. Yet the decision provided no explanation for nevertheless deeming Farhang's asserted inability to pay to be relevant to, indeed singularly determinative of, the ultimate ruling on a civil penalty, when it declared that payment of the penalty "will be waived." Neither of the two cases cited by the initial decision as its only support for ordering and then unilaterally "waiving" payment of the penalty did what the initial decision did. Rather, in each case the court reached conclusions about ability to pay that the court factored into its determination of what, if any, civil penalty to impose in the first place.[12/] Farhang provides no other support for, and does not urge, the initial decision's actual holding in this regard. Instead, he mischaracterizes the decision as having "waived" the civil penalty "in order to comply with [] Section 105(b)(3)'s limit on sanctions, and to respond to constitutional issues raised by Respondent" (Br. 10; Reply Br. 12 n.14), when, in fact, the decision squarely rejected his Section 105(b)(3) and constitutional arguments.

Accordingly, we treat the issue before us as not whether to provide relief from a civil money penalty once imposed, but rather, whether there is reason for us to take account of Farhang's ability to pay as we consider what, if any, civil money penalty to impose. Because of the egregiousness of the conduct, as discussed above, we do not view information about Farhang's ability to pay as relevant to the question of what, if any, civil money penalty to impose in this case. In any event, where inability to pay is relevant, the person claiming it bears the burden of proving it, *see, e.g., Vladlen "Larry" Vindman*, SEC Rel. No. 34-53654, 2006 WL 985308, *9 (Apr. 14, 2006), and the record here would not persuade us that Farhang is unable to pay the civil money penalty.[13/]

[12/] *See SEC v. Rubin*, 1993 WL 405428, *6-*7 (S.D.N.Y. Oct. 8, 1993); *SEC v. Mohn*, 2005 WL 2179340, *9 (E.D. Mich. Sept. 9, 2005); *see also SEC v. Warren*, 534 F.3d 1368, 1369 (11th Cir. 2008) (using term "waiver" to refer to when a law enforcement organization, in its discretion, forgoes pursuit of monetary relief). Also unlike the present case, *Rubin* and *Mohn* noted that a civil penalty would be in addition to a full measure of other monetary relief, and *Mohn* reasoned that it was "in the interests of judicial economy" to refrain from imposing a civil penalty "rather than assessing civil penalties against [defendants] and waiting for them to seek a waiver" from the court, which could preside over an action to collect that same penalty.

[13/] The initial decision decided inability to pay in Farhang's favor without addressing the Division's hearing request, made overly general or conclusory observations, and did not discuss in any detail, for example, the Division's specific arguments about Farhang's showing and his concession that he could pay some civil money penalty.

VIII.

For the reasons described above, we conclude that, in order to protect the interests of investors and to further the public interest, Farhang should be censured, permanently barred from associating with any registered public accounting firm, and required to pay a civil money penalty of $50,000.

An appropriate order will issue.[14/]

By the Board.

[14/] We have considered all of the parties' contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion. Farhang raised two additional legal challenges in his motion for summary disposition before the hearing officer that he did not specify in his petition for Board review nor mention in his briefs to the Board. R.D. 22a at 21-23. Farhang's opening appeal brief purports to "incorporate[] all of the arguments in his underlying Memorandum of Points and Authorities in Support of his Motion for Summary Disposition." Br. 5. To the extent he seeks by that means, rather than by his petition for review, to raise the two additional issues, those challenges are waived. *See* PCAOB Rule 5460(d) (unless the Board otherwise specifies, "[r]eview by the Board of an initial decision shall be limited to the issues specified in the petition for review"); *see generally, e.g., Laurie Jones Canady*, SEC Rel. No. 34-41250, 1999 WL 183600, *12 (Apr. 5, 1999). Furthermore, contrary to Farhang's purported "incorporat[ion]," any arguments not included in a party's appeal briefing, even if on points raised in the petition for review, are subject to waiver, as the parties here were advised when the Board's briefing order was distributed. R.D. 29 at 4; *see Mark E. Laccetti, CPA*, PCAOB Rel. No. 105-2006-007, 69 n.24 (Jan. 26, 2015), *sustained*, SEC Rel. No. 34-78764, 2016 WL 4582401 (Sept. 2, 2016), *appeal filed*, No. 16-1368 (D.C. Cir. Oct. 26, 2016). PCAOB Rule 5462(b) requires that, in briefs filed with the Board, "[e]ach exception to the findings or conclusions being reviewed shall be stated succinctly. Exceptions shall be supported by citation to the relevant portions of the record, including references to the specific pages relied upon, and by concise argument including citation of such statutes, decisions and other authorities as may be relevant." Reference in briefing to a prior filing in the proceeding does not satisfy this requirement and would have the effect of undermining the length limitations in PCAOB Rule 5462(c).

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of S. Brent Farhang, CPA,

Respondent

PCAOB File No. 105-2016-001

ORDER IMPOSING SANCTIONS

March 16, 2017

On the basis of the Board's opinion issued this day it is

ORDERED that S. Brent Farhang is censured; and it is further

ORDERED that S. Brent Farhang is barred from associating with any registered public accounting firm; and it is further

ORDERED that S. Brent Farhang shall pay a civil money penalty in the amount of $50,000 by (a) United States postal money order, certified check, bank cashier's check, or bank money order, (b) made payable to the Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies S. Brent Farhang as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the date the Commission lifts the stay imposed by Sarbanes-Oxley Act Section 105(e), 15 U.S.C. 7215(e).

By the Board.

Phoebe W. Brown
Secretary

March 16, 2017

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Mark E. Laccetti, CPA,

Respondent

PCAOB File No. 105-2009-007

FINAL DECISION

January 26, 2015

Appearances

Michael Plotnick, Esq., William F. Ryan, Esq., and Philip J. Berkowitz, Esq., Washington, DC, for the Division of Enforcement and Investigations

Lawrence J. Zweifach, Esq., Michael J. Scanlon, Esq., and Darcy C. Harris, Esq., Gibson, Dunn & Crutcher LLP, Washington, DC, for Respondent

I.

In this disciplinary proceeding, Respondent Mark E. Laccetti is charged with violating PCAOB rules and auditing standards in connection with the audit of a foreign private issuer's consolidated financial statements for the year ending December 31, 2004. The auditor of those financial statements assigned part of the audit—the audit of the issuer's United States subsidiary—to another independent auditor, with which Laccetti was associated. Laccetti served as the auditor with final responsibility for the audit of that subsidiary. The subsidiary, like its parent, recognized revenue at the time its products were sold, and, in undertaking to comply with United States generally accepted accounting principles, estimated, deducted from sales, and recorded in accounts receivable reserves, the amounts it expected to incur on those sales for various sales incentives it offered to its customers. Laccetti is charged with failure to exercise due professional care, including professional skepticism, with failure to obtain sufficient competent audit evidence, and with certain other violations, concerning the audit work on these reserves in total and for the largest sales discount, chargebacks. The parent company later restated its financial statements for 2004 and other periods, principally due to the subsidiary's erroneously low chargebacks estimates, which had caused multi-million-dollar overstatements of net sales and related receivables.

After holding a hearing, the hearing officer issued an initial decision finding that the Division of Enforcement and Investigations had proven certain, but not other, of the alleged violations against Laccetti by a preponderance of the evidence. The initial decision imposed the sanctions of a six-month suspension from association with any registered public accounting firm and a $25,000 civil money penalty for the violations found, and otherwise dismissed the case against Laccetti. Laccetti petitions for review of the decision's admission of certain evidence, its disposition of the charges on which sanctions were imposed, and the sanctions. The Division petitions for review of the hearing officer's exclusion of certain evidence, the initial decision's disposition of all but one of the charges it dismissed, and its determination of sanctions.

We have reviewed the record in this case *de novo*, except as to those findings not challenged on appeal, in light of the briefs and oral argument presented to us. We find that Laccetti violated PCAOB rules and auditing standards, with respect to audit work for which he was responsible on the United States subsidiary's total, year-end 2004 accounts receivable reserves. He did so by failing to exercise due professional care, failing to obtain sufficient audit evidence, failing to adequately perform procedures to evaluate the reasonableness of a significant accounting estimate, and improperly relying on management representations. We further find that this conduct, along with the failure to perform an audit procedure to review the estimate for biases that could result in material misstatement due to fraud, was reckless, or, at a minimum, repeatedly negligent, we bar Laccetti from associating with a registered public accounting firm, provided that he may petition the Board to associate with such a firm after two years, and we order him to pay an $85,000 civil money penalty.

II.

On October 20, 2009, the Board issued an Order Instituting Disciplinary Proceedings (OIP) alleging violations of PCAOB rules and auditing standards by Mark E. Laccetti, in auditing the 2004 financial data of Taro Pharmaceutical U.S.A., Inc., a subsidiary of Taro Pharmaceutical Industries Ltd. The audit of this subsidiary was conducted in connection with another independent auditor's issuance of an audit report on the 2004 consolidated financial statements of the parent company. At all relevant times, the parent company was an issuer, as defined by Section 2(a)(7) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(7), and PCAOB rules, and Laccetti was a person associated with a registered public accounting firm—Ernst & Young LLP—as defined by Section 2(a)(9) of the Act, 15 U.S.C. 7201(9), and PCAOB rules. Laccetti filed his Answer on December 7, 2009. Following nine days of hearings in June and July 2010, the hearing officer issued the initial decision on April 20, 2011. The Division and Laccetti both petitioned for review of the decision. Briefing concluded on October 25, 2011. The Board heard oral argument in the case on March 13, 2012.

III.

Based on our review of the record, we find the facts to be as follows.[1/]

[1/] In light of ample other evidence presented in this proceeding, we need not, and do not, rely on any of the materials whose admission into, or exclusion from, evidence is

A. Laccetti Was the Auditor With Final Responsibility for the 2004 Audit of a United States Pharmaceutical Company, a Major Subsidiary of an Israel-Based Issuer Audited by Another Independent Auditor.

Laccetti was the auditor with final responsibility, or engagement partner, for Ernst & Young's audit of the financial information of Taro Pharmaceutical U.S.A., Inc. (Taro USA) for the year ending December 31, 2004. *See, e.g.*, AU §§ 230.06, 311.02, 316.74. He had been associated with Ernst & Young since 1989, had joined the Taro USA engagement in January 2004, as senior manager on the 2003 audit, and had been promoted to partner in July 2004. Hearing Exhibit (Ex.) L-108 at 3; Index to the Record on Review, Record Document (R.D.) 135 at 195-96, 241 & R.D. 137 at 661, 667, 672, 703 (Laccetti). Other than Laccetti, the 2004 Taro USA audit team was effectively new to the engagement, consisting of a senior manager and a staff accountant who served as "acting senior" auditor. Ex. J-4 at 22; R.D. 137 at 706-08, R.D. 139a at 1009-11.

Taro USA was the United States subsidiary of Taro Pharmaceutical Industries Ltd. (parent company), a multinational company, based in Israel, that developed, manufactured, and marketed pharmaceutical products. During the relevant period, Taro USA did not issue financial statements, but its parent company issued audited annual financial statements on a consolidated basis, incorporating its subsidiaries' financial information. As a foreign private issuer, the parent company filed annual reports on Form 20-F, including its financial statements, with the United States Securities and Exchange Commission (SEC or Commission), and its stock was publicly traded in the United States on the NASDAQ National Market. The parent company was not required to file quarterly reports, but it did issue press releases about its quarterly financial results, and its audit committee chairman had asked its auditor to arrange for Ernst & Young to perform limited quarterly reviews of Taro USA. R.D. 141 at 1497-1501.

As with prior-year audits of Taro USA, the audit for 2004 had been assigned to Ernst & Young by another independent auditor, an Israeli firm, which served as the principal auditor of the parent company's consolidated financial statements. *See* AU § 543, *Part of Audit Performed by Other Independent Auditors*. The principal auditor's September 2004 engagement instructions directed Ernst & Young to perform a "full scope US GAAP [generally accepted accounting principles] and GAAS [generally accepted auditing standards] audit on the trial balances" in Taro USA's "reporting package" of its financial information for 2004, including its balance sheet and statement of income. Ex. J-2 at 1, 7, 9, 19; Ex. J-26 at 6, 8, 20; Ex. D-72 at 3; R.D. 139a at 1070-71 (principal auditor's engagement partner); R.D. 135 at 231-34, R.D. 137 at 677 (Laccetti); *see* Ex. D-126 at 1. It is undisputed that this required an audit conducted in accordance with PCAOB standards. Initial Decision (I.D.) 20, 35; *see, e.g.*, Ex. J-17 at

challenged before us by the parties, nor do we rely on Laccetti's investigative testimony. *See* Sections VI(A), VI(B), and VII(A) below.

102; Ex. R-12 at 7 (Taro USA letter to Ernst & Young); R.D. 141 at 1520-21 (principal auditor's engagement partner). Laccetti understood that the principal auditor planned to use the 2004 Taro USA audit work in its audit of the parent company's 2004 consolidated financial statements, included in Form 20-F to be filed with the SEC. Ex. D-72 at 3; *see* Ex. D-126 at 1-2; R.D. 139a at 985 (Laccetti). The principal auditor issued an unqualified opinion on those financial statements. Ex. J-17 at 102.

Taro USA sold mainly generic, but also some branded, pharmaceutical products. Its customers were primarily large wholesale drug companies. In 2002, 2003, and 2004, its three largest wholesale customers contributed around 40% or more of the parent company's consolidated sales. Ex. J-1 at 35; Ex. J-17 at 33. Taro USA sold to wholesalers subject to various adjustments to the price of sales, including chargebacks, rebates, billbacks, and return rights. In Forms 20-F for 2003 and 2004, the parent company made clear, on behalf of itself and its subsidiaries, that "[t]he pharmaceutical industry in which we operate is intensely competitive," "[w]e are particularly subject to the risks of competition," "[t]he nature of our business requires us to estimate future charges against wholesaler accounts receivable," and sales incentives (or allowances) were used to promote sales in this competitive market. Ex. J-1 at 9, 15, 36, 38, 46, 47; Ex. J-17 at 8, 14, 34, 36, 41, 42; *see* R.D. 137 at 749-52 (Laccetti).

The wholesalers, in turn, sold the products to drug stores, hospitals, and other health care providers. A wholesaler was entitled to a chargeback when it sold a Taro USA product to a customer who had an agreement directly with Taro USA to buy such products at specified prices that were less than the gross sales amounts that Taro USA charged the wholesaler (wholesale acquisition cost or WAC). By agreement, the wholesaler would sell the product to the customer at the specified price and then submit a chargeback to Taro USA for the difference between that price and the WAC.

Taro USA's parent company reported that it prepared its financial statements in accordance with United States generally accepted accounting principles (GAAP). Ex. J-1 at 3, 47, 118; Ex. J-17 at 3, 44, 116; *see* Ex. J-26 at 5. Taro USA, like its parent, recognized revenue from product sales "when the merchandise [was] shipped to an unrelated third party," rather than when payment was received. Ex. D-63 at 5 (2004 Taro USA audit work paper); *see* Ex. J-1 at 47; Ex. J-17 at 43-44. In doing so, Taro USA represented, among other things, that the selling price of its products was fixed or determinable and that it could reasonably estimate the sales allowances it would incur on the sales, consistent with Statement of Financial Accounting Standards (FAS or SFAS) No. 48, *Revenue Recognition When Right of Return Exists*, ¶ 6, and SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. R.D. 135 at 204, R.D. 137 at 506-07 (Laccetti); Ex. D-63 at 5; *see* Ex. J-1 at 121, 125; Ex. J-17 at 44, 116.

Accordingly, Taro USA estimated, deducted from sales, and recorded in accounts receivable reserve accounts the amounts of sales allowances, such as chargebacks, rebates, billbacks, and return rights, it expected to incur on those sales.

Ex. D-63 at 5; Ex. L-22 at 17-22; *see* Ex. J-1 at 47; Ex. J-17 at 43. Those sales adjustments contributed substantially to reducing the parent company's gross sales to the reported net sales on its Consolidated Statement of Income and, at the same time, to reducing the parent company's gross accounts receivable to the net accounts receivable reported on its Consolidated Balance Sheet. In 2002, 2003, and 2004, Taro USA contributed more than 85% of the consolidated net sales, more than 90% of the year-end consolidated net accounts receivable, and more than 90% of the year-end consolidated accounts receivable reserves reported by the parent company. Ex. J-1 at 34, 109 (Form 20-F for 2003); Ex. J-17 at 33, 45, 103 (Form 20-F for 2004); Ex. D-278 at 3; Ex. D-294 at 4; Ex L-22 at 8. In 2004, Taro USA's gross sales totaled approximately $580 million and were reduced, by the various sales allowances, to net sales of about $248 million, which were consolidated into the parent company's total reported revenue of about $284 million. Ex. L-22 at 14-15; Ex. J-17 at 33, 105.

Compared to 2003, Taro USA's 2004 gross sales rose by $28 million and its year-end 2004 gross accounts receivable grew by nearly $12 million to $165 million. By contrast, year-end accounts receivable reserves rose by only $1 million to $42 million. Ex. L-22 at 2. Certain audit testing showed that, on average, Taro USA's receivables were going unpaid significantly longer in 2004 than in 2003, which could indicate a problem with the reserves. *E.g., id.* at 8; R.D. 139a at 923-25; R.D. 180 at 86.

In 2004, as in 2003, chargebacks represented the largest sales allowance reflected in Taro USA's and its parent's financial data. Ex. L-22 at 14-15; Ex. D-294 at 1, 4; Ex. J-17 at 45. Taro USA did not prepare a detailed calculation or specific estimate to support its year-end 2004 chargebacks reserve, as it did for its other sales allowance reserves, and, unlike the others, Laccetti assessed chargebacks as a component of accounts receivable reserves in total, rather than individually. Ex. L-22 at 20, 22. Despite higher recorded gross sales, sales adjustments, and year-end gross receivables and reserves in 2004, the chargebacks reserve fell by 87%, to $2.37 million, from the largest component of the reserves in 2003 to one of the smallest. *Id.* at 2.

B. In Planning the 2004 Taro USA Audit, Laccetti Knew That the Company's Processes for Estimating Sales Allowances Had Not Been Strong and Understood That the Audit Needed To Focus on the Related High-Risk Areas of Revenue Recognition and Accounts Receivable Allowances.

Laccetti led the planning of the 2004 Taro USA audit. R.D. 137 at 775-76. In doing so, he recognized that accounts receivable allowances was an area of high risk and focus in the audit. R.D. 135 at 273-74; R.D. 139a at 971-72. He knew that, after the 2002 and 2003 audits, the principal auditor had commented to Taro USA's parent company, with Ernst & Young's input, that Taro USA lacked a formalized methodology for preparing and reviewing accounts receivable allowance estimates and had suggested improvements. R.D. 137 at 799-801, 813-14; Exs. J-27 at 4, D-21 at 3, and D-18 at 2 (management letters from the auditors). He also knew going into the 2004 audit that, just the year before, the Ernst & Young audit team, to which he belonged, had increased the combined risk assessment for Taro USA's valuation assertion of accounts receivable allowances from moderate to high. R.D. 135 at 216; Ex. D-3 at 7.

The principal auditor's engagement instructions for the 2004 Taro USA audit identified "revenue recognition" as an area of "primary importance" and stated, "Special attention should be given to allowance for rebates, discounts and returns," a directive that included chargebacks. Ex. J-26 at 30; *see* R.D. 141 at 1528 (principal auditor's engagement partner). The instructions also informed Laccetti that "accounts receivables and revenue recognition (including allowance for rebates, discounts and returns)" would, along with several other areas, be the principal auditor's "emphasis during the audit" of the parent company, "[d]ue to [certain] changes" in "significant accounting and audit issues" from 2003. Ex. J-26 at 3. The instructions pointed out several such changes, two of note here. The first was that customers had "withheld from payment" to Taro USA approximately $20 million "in error" as sales allowances, that Taro USA had included this amount in accounts receivable as of March 31, 2004, and that $16 million remained unpaid as of June 30, 2004. The parent company "believes that these amounts were withheld in error and that substantially all of these errors will be rectified in due course." *Id.* The second, described as a "material change in business," was "a substantial decrease in [the parent company's consolidated] sales," leading to "a loss of $8.9 million in the second quarter of 2004," a drop in share price "to $20 from average price of $60," and the filing of "several class action lawsuits against [its] management." *Id.* at 3, 6*; see* Ex. J-29 at 7. This was largely due to Taro USA's results. *E.g.*, Ex. D-72 at 3-4. Before year-end 2004, Laccetti signed and returned to the principal auditor the acknowledgement forms in the instructions. Ex. J-26 at 14-18.

Laccetti led the preparation of various audit planning documents. One was an Audit Strategies Memorandum, which, after input from the principal auditor, was finalized on January 5, 2005. Ex. D-72; R.D. 139a at 882-83, 980-81. It discussed "Significant Accounting and Auditing Issues" involved in the Taro USA audit and set forth a plan for the audit. Another, provided to the principal auditor along with that memorandum, was an Internal Control and Fraud Considerations form identifying certain fraud risks and audit responses. *Id.* at 883-85; Ex. J-29. And another was the Preliminary Audit Strategy by Significant Account document (Ex. D-74), "an overview of our preliminary audit strategy for each significant account" (Ex. D-72 at 10).

The Audit Strategies Memorandum discussed the roughly $20 million that, in the parent company's view, had been erroneously withheld from payment to Taro USA by wholesalers, to which reference was made in the engagement instructions. Of note here, the memorandum stated that around $11 million, representing chargebacks Taro USA calculated it had "erroneously returned to the wholesalers" and "expects to collect," still remained unrepaid. Ex. D-72 at 5. The document explained that Taro USA's error resulted from basing the chargebacks on the increased wholesale acquisition cost, or WAC, charged by the company to the wholesalers as of July 1, 2003, when, in fact, the wholesalers had purchased some of the product at issue at the lower WAC in effect before July 1, 2003. *Id.* at 4-5. Taro USA had discovered its mistake in the first quarter of 2004, "as cash decreased and the chargeback's reserve decreased." *Id.* at 5. An audit work paper noted the excess chargebacks had been taken by the three largest wholesalers and Taro USA had "requested on May 27, 2004 that the difference be returned." Ex. L-22 at 3. According to the Audit Strategies Memorandum, Taro USA calculated the "'over-chargeback's'" by "estimat[ing] the amount of inventory held by the wholesalers at July 1 to be equal to the purchases from the prior six months." Ex. D-72 at 5. Taro USA "has increased accounts receivable for the entire $11 million and has also reserved the entire amount" of that increase. *Id.* Later in the audit, Laccetti learned that Taro USA maintained the $11 million receivable, but not any reserve for it, at year end 2004. *E.g.,* Ex. D-88 at 3; Ex. D-234 at 2; Ex. R-12 at 3; R.D. 139a at 1020.

The Audit Strategies Memorandum also spoke to the decrease in second quarter 2004 sales referenced in the engagement instructions. It stated that Taro USA halved or eliminated during that quarter a promotional discount of 10% offered to wholesalers on all products. Ex. D-72 at 3. This caused "a large decrease" in Taro USA's second-quarter sales, as the wholesalers "reduced their sales orders and operated off of the inventory on hand." *Id.* at 4. But, "as wholesalers inventories depleted," Taro USA's sales "began to recover," with third quarter 2004 sales "show[ing] a positive trend in the sales of most products." *Id.* Laccetti cited this recovery of sales when the principal auditor asked, in commenting on the draft memorandum, about how the second-quarter sales decline was consistent with the team's "analytical review where you state that promotional discounts increased during 2004." *Id.* at 3. *See* Ex. J-29 at 7.

Regarding the audit plan, the memorandum stated that the "nature, timing, and extent of our planned audit procedures have been developed in response to the combined risk assessment for each significant account." Ex. D-72 at 10. It identified "[a]ccounts receivable allowances" as one of five separate Taro USA accounts for which the valuation assertion was of "higher inherent risk" and among the four of these accounts for which this assessment was "due to the inherent subjectivity in the estimations processes." *Id.* at 9. Noting that the "[n]ature of A/R allowances is such that significant estimation is used," the Preliminary Audit Strategy document identified "Accounts Receivable Allowances" and "Sales" as significant accounts, each with "higher" inherent risk, "maximum" control risk, and "high" combined risk as to valuation. Ex. L-1 at 3; Ex. D-75 at 1; Ex. D-63 at 6 (combined risk assessment for valuation and measurement of revenue was "High"). *See* R.D. 135 at 321 (Laccetti).

As to fraud risks, the Internal Control and Fraud Considerations document specified "[i]mproper revenue recognition" and "[m]anipulating significant accounting estimates," including "accounts receivable allowances," as one of three "Identified Fraud Risks." Ex. J-29 at 6. It observed that Taro USA "is subject to significant pricing pressures and low margins" relating to generic pharmaceuticals that "creates pressure on meeting sales goals" and "could lead to improper revenue recognition," and noted that "[m]anagement's estimation processes for accounting estimates have historically not been strong." *Id.* In addition, the document indicated that "[i]neffective accounting and information systems" was a "risk factor[ ] to be considered relating to opportunities associated with misstatements arising from fraudulent financial reporting." *Id.* at 27. Although the document also stated that, while "[r]ecent improvements have been made to the accounts receivable allowance estimation process," this "still remains an area of significant subjectivity" (*id.* at 6), Laccetti testified that he was not aware during the 2004 audit of any such improvements having been made, that this language was directly carried over from the Internal Control and Fraud Considerations document for the prior year's audit of Taro USA, and that he could not remember having been aware of any recent improvements during the 2003 audit either. R.D. 135 at 281-82. By contrast to the allowances, the audit team's combined risk assessment for gross accounts receivable was "Minimal," and the auditors did not identify fraud risks for that account. Ex. L-1 at 1; Ex. L-22 at 1636.

The Ernst & Young audit team did not plan to perform substantive procedures specifically to test the estimates of items that reduced gross sales to net sales on Taro USA's income statement because the team instead would rely on testing with respect to the balance sheet. R.D. 135 at 322 (Laccetti). Moreover, in the accounts receivable allowances area, the audit team planned to perform substantive procedures and not to rely on testing of internal controls, which the team determined were ineffective. Ex. L-1 at 3; R.D. 135 at 315-17 (Laccetti); R.D. 137 at 523-24 (same); *see* R.D. 135 at 283-86.

The audit team stated that to address the risks identified in the Audit Strategies Memorandum, it would "review the client's [accounts receivable] reserves and methodology in detail" and "perform substantive procedures on the allowances at year-end," and specifically it would "perform procedures to determine the reasonableness" of 14 listed "allowances and rebates," including chargebacks. Ex. D-72 at 6. To this end, management would provide the audit team with "an analysis of the allowances, which will include an analysis of the overall realization of accounts receivable (cash collections as a percentage of gross accounts receivable)." *Id.* The Preliminary Audit Strategy document specified that the team would "[o]btain an understanding of how" each of certain sales allowances, including chargebacks, "is established and evaluate whether this method is adequate," as well as "[r]eview the overall reserve calculation as of December 31 and the related accounts." Ex. D-74 at 2, 3.

Regarding chargebacks, in particular, the audit plan was to: (1) "[c]ompare the allowance for chargebacks with that of prior periods and investigate any unexpected changes (or the absence of expected changes)"; (2) "[d]etermine reasonableness of reserve for chargebacks by calculating chargebacks as a percentage of sales and analyzing trend of chargebacks using the September and December aging and the most recent aging"; (3) "[o]n a test basis compare amounts accrued to contracts for reasonableness"; and (4) "[r]eview charge-backs > 25% of TE [tolerable error] that occurred subsequent to year end to determine if they related to the receivable balance as of December 31," in addition to more generally "[p]erform[ing] a search for all credits issued subsequent to year end exceeding 25% of TE to assure proper allowances have been established." Ex. L-1 at 5-7; *see* Ex. D-46 at 48-49; R.D. 135 at 327-30.[2/]

To address the identified fraud risk of improper revenue recognition, the audit team wrote that it planned to, among other things, "[p]erform detailed and analytical review procedures on significant accounting estimates related to revenues." Ex. J-29 at 8. In particular, the team set forth three planned audit responses to the fraud risk relating to biases in significant accounting estimates: (1) "[p]erform detail testing and analytical review procedures, including hindsight review, of all significant accounting estimates"; (2) "[d]ocument our understanding of the client's processes and determine whether there appears to be any management bias"; and (3) "[d]etermine whether management is consistently recording estimates." *Id.*

C. Laccetti Faced a Process Deficiency in Taro USA's Estimation of Sales Allowances, Difficulty Obtaining Information and Analysis To Support the Year-End Reserves, and Cause for Concern About the Reserves.

During the 2004 Taro USA audit, Laccetti encountered what he determined to be a process deficiency in the company's estimation of its sales allowances, which, as noted, the company recorded both as deductions to sales and as accounts receivable reserves; difficulty in obtaining information and analysis to support Taro USA's year-end 2004 accounts receivable reserves; and audit evidence that raised concerns about the reserves. At the time of the audit, Laccetti summarized these circumstances by stating, "Due to the fact that the Company can not give us lag reports related to subsequent cash receipts or accounts receivable allowances and the fact that they have no formal methodology to test, it is difficult to review appropriateness of allowance without looking at trends and specific accounts." Ex. D-100 at 1-2. On February 8, 2005, several days after the original deadline for completing the field work for the 2004 audit, he reported to the principal auditor that the audit team's accounts receivable analysis was not favorable, that the team was not comfortable that the accounts receivable were fairly stated, and that this message had been conveyed to Taro USA. Ex. D-87 at 1. Even

[2/] The principal auditor set tolerable error at $360,000 for the Taro USA audit. Ex. J-26 at 6; Ex. D-72 at 10; Ex. D-126 at 1; Ex. L-22 at 1636; R.D. 135 at 233-34. Tolerable error or "tolerable misstatement" is "a planning concept and is related to the auditor's preliminary judgments about materiality levels in such a way that tolerable misstatement, combined for the entire audit plan, does not exceed those estimates." AU § 350.18, .48. The engagement instructions explained that tolerable error "has been assigned to each [subsidiary] based upon the overall size of the [subsidiary] and the risk of financial statement misstatement as determined by the [principal auditor's audit team]. The TE assigned is to be used at each Location as a starting point for establishing testing thresholds/scopes." Ex. J-26 at 6; *see* R.D. 139a at 1075-78.

when Laccetti expressed ultimate satisfaction with the allowances in a February 18, 2005 draft memorandum to the principal auditor, the principal auditor's engagement partner sensed hesitancy on Laccetti's part. Ex. D-100; R.D. 140a at 1284-85.

1. Laccetti found Taro USA had a deficient process for preparing and reviewing accounts receivable allowance estimates.

Laccetti discussed Taro USA's process deficiency with the principal auditor's engagement partner during February and March 2005. The Israeli partner's notes of February 10, 2005 discussions with Laccetti state, "No orderly process" and "Issue with allowances" or, alternatively, "There is no organized process. It might be a problem, it might be issues with reserves." Ex. D-89; R.D. 139a at 1130. The partner's notes of the discussions explain that "there is a problem with monitoring the reserves that should be made. There are no formalized procedures and no structured process for evaluating the required level of reserves. Part of the problem stems from a lack of information about the stock levels at the wholesalers." Ex. D-91; Ex. D-234 at 1 (translation). Laccetti knew that inventory levels in the hands of the wholesalers was a factor that should be taken into account in considering Taro USA's ability to reasonably estimate accounts receivable allowances. Ex. J-27 at 4; R.D. 135 at 207 (Laccetti). And he understood that Taro USA's current agreements with wholesalers did not "give[ ] information about the stock levels [of its products] at the wholesalers." Ex. D-234 at 2.

Indeed, on January 26, 2005, Laccetti had reviewed and included in the audit work papers a December 17, 2004 letter to SEC staff from Taro USA's parent company, which stressed subjectivity in the estimates of account receivable allowances and indicated limitations on access to information about the wholesale customers' inventory levels. R.D. 135 at 261-63, 266-67; *see* Ex. D-44 at 3. The letter responded to a November 24, 2004 letter from SEC staff suggesting that the parent company's description of its revenue recognition practices in the "Critical Accounting Policies" section of its Form 20-F for 2003 could be improved by adding certain disclosures. Ex. D-37. The response letter represented, "We determine the amounts to accrue and reserve subjectively, on the basis of our decades-long historical experience rather than on the basis of any particular or quantifiable objective assumptions." Consequently, the letter stated, "there are no (i) 'other reasonably likely assumptions' on the basis of which we might determine the amount of our accruals and reserves differently or (ii) objective criteria that we could alter in order to perform a sensitivity analysis." It also represented that "the substantially most determinative factor that we consider in establishing accruals and reserves is our historical experience." According to the parent company, "We have no way of knowing or reasonably estimating (i) the actual levels of inventory in our distribution channels or (ii) the then-current inventory policies, or desired inventory levels, of our distributors. Because we do not know, and cannot reasonably estimate, either the amount or the age of our distributors' inventories, we are also unable to estimate remaining shelf lives, except on the basis of our historical experience." The letter emphasized that the company's sales allowance estimates are "based primarily upon historical amounts of Sales Allowances, rather than the causes of such Sales Allowances." Ex. D-44 at 3-4 (emphasis in original).[3/]

In a February 13, 2005 email, the principal auditor's engagement partner raised with Laccetti the prospect that additional accounts receivable reserves might need to be recorded and "a material weakness under SAS 60" noted. Ex. J-5 at 1-2. In response, Laccetti referred to the issue as "a lack of a process for establishing an AR reserve" and stated that "[u]nless we conclude that the AR reserves need to be adjusted," the "AR reserve process" "should be noted as [a] reportable condition[ ]." *Id.* at 1.[4/]

In the draft Summary Review Memorandum, sent to the principal auditor on February 18, 2005, Laccetti described the deficiency in the following terms: "We noted

[3/] The SEC staff wrote to the parent company again on March 24, 2005, stating again that its "disclosure related to estimates of items that reduce gross revenue such as product returns, chargebacks, customer rebates and other discounts and allowances are material and could be improved," questioning "why you believe you have met the conditions of paragraphs 6 and 8 from SFAS 48, such that you recognize revenue at time of receipt by wholesalers," and asking it to "revise the financial statements or more fully disclose how your revenue recognition complies with SFAS 48 and SAB 104." Ex. D-294 at 3, 5. A new response, copied to Laccetti for comment on May 23 (Ex. D-294) and discussed in a May 26, 2005 conference call that included the principal auditor's engagement partner and Laccetti (R.D. 141 at 1758), expanded on the parent company's prior letter. In particular, the company's new letter stated it "would like to make the following clarification" as to "the actual levels of inventory in the distribution channel": "While we are not provided with detailed inventory reports directly by our customers, we monitor inventory in the channels based on customers' orders, customers' submissions of their sales to third parties, third party reports of prescriptions written, third party sales data, and our experience and historical data, including the amounts and levels of actual returns and rebates." Ex. D-294 at 6.

[4/] Statement on Auditing Standards (SAS) 60 defined a reportable condition as a matter coming to the auditor's attention during the audit that, "in his judgment, should be communicated to the audit committee because [it] represent[s] significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements." SAS 60 noted that a reportable condition "may be of such magnitude as to be considered a material weakness," which it defined as "a reportable condition in which the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions."

that [Taro USA's] accounts receivable reserve process is not done in a timely manner and the estimation methodology has not been defined and monitored for the most updated trends. We consider this deficiency to be a reportable condition, which…will need to be addressed as the Company prepares for Section 404 [of the Sarbanes-Oxley Act, 15 U.S.C. 7262,] reporting in 2005. This reportable condition should be communicated to the Audit Committee." Ex. J-6 at 5; *see* Ex. D-54 at 6 (Taro USA audit team's February 24, 2005 Accounts Receivable Allowances Memorandum, also sent to the principal auditor: "We will provide a management letter comment concerning the estimation process used as they relate to account receivable allowances.").

On March 3, 2005, Laccetti indicated his view of the difficulty that the process deficiency had presented for the Taro USA audit, when the Israeli partner asked him to clarify the above description, in advance of a March 8, 2005 meeting with the audit committee. The Israeli partner asked, "I just wanted to make sure that when you said in a timely manner you mean that [Taro USA's accounts receivable] process is not done on a periodic basis. The [chief financial officer] had the idea that you meant that when you started the audit it was still not prepared." Ex. D-117 at 2. Laccetti responded:

> The main issue is they have no method[o]logy or process for making a sound estimate of AR allowances. I believe we did receive some information late in the audit process, but the bigger issue is the fact that we s[p]ent the whole audit trying to justify a number as they had no methodology for us to audit. They do book allowances through-out the year, so that is not really the issue, the issue is they have no real basis for the amounts they record. If timely is an issue I have no issue with dropping the reference to timely.

Id. at 1; *see* Ex. D-114 at 1 (March 3, 2005 email from Laccetti to senior manager of Taro USA audit about Israeli partner's question "related to timeliness of the ar process," stating, "To me more of the issue is that they have no process for creating an estimate."); Ex. D-115 (in response to Laccetti, senior manager wrote, "It relates to not having a timely or adequate process for creating an estimate.").[5/]

[5/] A further exchange took place on March 29, 2005, when the Israeli partner asked Laccetti for his reaction to the company's request to "change the wording" of certain audit findings that the principal auditor had based on Laccetti's description of the deficiency and planned to include in "the audit results presentation to Audit Committee." Ex. J-23. As to accounts receivable allowances, the company wanted to replace certain language—"We noted that [Taro USA's] accounts receivable reserve process is not done in a proper manner. The estimation methodology has not been defined and monitored for the most updated trends."—with "We noted that [Taro USA's] accounts receivable reserve process is not done in an efficient manner and the estimation

Also in March 2005, Laccetti reviewed and edited a comment, finding, and recommendation about the process deficiency, for inclusion, along with other points, in the principal auditor's management letter to Taro USA's parent company for the audit of the 2004 consolidated financial statements. Ex. J-25. As pertinent here, the document described the deficiency as a reportable condition and stated that:

> During our audit we determined that management did not have a formalized process in place for estimating reserves (i.e.[,] doubtful accounts, bill-backs, returns, rebates, discounts, charge-backs, etc….) for accounts receivable. In addition, timely preparations of reserve schedules were not given to us in a timely manner, delaying the timing of our audit procedures.
>
> ….Formal policies would establish a consistent method for determining the allowances and also assist management in providing monitoring information for review and control of the accounts receivable.
>
> The use of a consistent methodology would provide a basis for monitoring customer trends and performance by line of business as well as monitor the effectiveness of the Company's credit and collection practices. The assumptions used in the method should be evaluated each year against actual data to determine whether they remain appropriate.
>
> In addition, the company should review the year end audit list that is sent by E & Y to ensure that all schedules requested are prepared in a timely manner and will not delay audit procedures.

Id. at 1, 2-3; R.D. 139a at 954-56.

2. Laccetti had difficulty obtaining data and analysis about the year-end allowance reserve and was concerned about its adequacy.

On February 1, 2005, days before the deadline for completion of the field work on the 2004 Taro USA audit, Laccetti had not yet received various items from Taro USA, including a final trial balance "as it relates to the significant account[ ] of Accounts receivable." Ex. D-87 at 2 (senior manager email); *see* Ex. D-34 at 2; R.D. 137 at 717-21 (Laccetti). Laccetti met with management on February 4, 2005, in part to discuss issues pertaining to accounts receivable reserves, including several prepared schedules—an Accounts Receivable Summary for 2001 to 2004; a Sales Allowance Analysis for 2004; and a Cash Collections sheet for 2003 and 2004. Exs. D-79 at 2-3, 6, 7, D-80, D-81. At that time, Laccetti shared with Taro USA an accounts receivable

methodology has not been defined." Laccetti commented, "I think th[eir] change still gets the substance of the comment across, so I am OK with their re-write." *Id.* at 1-2.

analysis, described as follows in his testimony: "in performing our initial procedures and looking at the trends," including "the trend of the days sales [in] receivables," "it wasn't what we were expecting." R.D. 135 at 409-10, R.D. 139a at 1012-13; Ex. D-87 at 1.

Days sales outstanding or days sales in accounts receivable (DSR) is a calculation of the average number of days for payment to be made on a company's sales. R.D. 135 at 260, R.D. 139a at 923-24. The audit team calculated DSR based on net accounts receivable (either the period-end figure or the average of that figure with net accounts receivable from the end of the prior period under comparison), divided by net sales for the period, and then multiplied by 360 days. *See, e.g.,* Ex. L-22 at 8. The team used DSR "to test the adequacy of [accounts receivable] reserves in total." Ex. L-22 at 22. Taro USA's rising DSR in 2004 had been a topic of conversation at the initial planning stages of the 2004 Taro USA audit. Ex. L-181 at 7-9, 14 (senior manager's investigative testimony). The Accounts Receivable Summary showed DSR rising from 110.99 days in 2003 to 170.84 days in 2004. Ex. D-79 at 2; *see* Ex. L-22 at 8.

In response to Laccetti's analysis, as reported in his and the senior manager's emails, Taro USA stated that it was investigating "some accounts receivable schedules that we have not received yet but are expected to receive [on February 7]," stated that it was "preparing some additional analysis for us," and "asked us to do some additional analysis from [a] different perspective." Exs. D-80, D-87 at 1. In a February 7 email, sent in draft and copied in final to Laccetti, to keep the principal auditor "informed of our progress and th[e] problems that we are dealing with," the senior manager wrote that "our optimistic plan is to finalize these issues this week (provided we get [Taro USA's] full cooperation and the appropriate analysis of these issues)[.]" Exs. D-80, D-81.

The resulting quarterly 2004 Accounts Receivable Summary showed, according to an email later on February 7 from the senior manager to Laccetti, that "days in A/R are continuing to increase each quarter. I don't think this makes the picture any better for [Taro USA]." Ex. D-82 at 1, 4-5. The email further stated that "I also decided to breakout the quarterly cash collected to see how this compared to gross sales and this indicated that the 4th quarter was not good. In addition, I put together a lag analysis using the assumption that it takes 110 days to collect the average receivable. This basically shows that there is still $48 million in outstanding receivables as of December 31, 2004 that do not relate to current quarter (older receivables)." Ex. D-82 at 1, 6 (attaching a Gross/Net Sales and Cash collection analysis, containing the breakout and comparison of cash collections and the lag analysis). A note on Laccetti's agenda for the February 4 meeting had stated, "QTRLY cash collection look." Ex. D-79 at 1.[6/]

[6/] Another note by Laccetti on that agenda stated, "QTRLY look @ divisional sales." Ex. D-79 at 1. The audit work papers indicate that Taro USA grouped its sales by several divisions, one of which sold "Branded RX" (prescription) products. Ex. L-22 at 8-11; Ex. D-63 at 59-62. A revenue work paper, "Gross sales by product," listed 2003

On February 8, 2005, the senior manager talked to Taro USA "about the quarterly data" and provided "an analysis on the last 5 months of cash collections which was not good," showing that it would take 244.34 days to collect the "A/R balance at 12/31/04," based on dividing year-end 2004 net accounts receivable by the average monthly collections for September 2004 through January 2005. Exs. D-83 at 1, 7, D-85 (senior manager's emails that day to Laccetti, attaching the analysis). The Gross/Net Sales and Cash collection sheet reflected an additional 2004 DSR calculation of 191.48 days based on dividing year-end net accounts receivable by cash collections and multiplying by 360 days, up from 168.39 days in 2003. Ex. D-82 at 6. The principal auditor's engagement partner, after talking with Laccetti around the same time, wrote, "There is a growth in the number of days of credit and in the sum of the customer debts, but there is no corresponding growth in the various reserves." Ex. D-91 (notes); Ex. D-234 at 1 (translation). The senior manager wrote to the company on February 8: "The days outstanding are high and the recent cash collections have not been great. Based on the analysis we need to consider if you are adequately reserved." Ex. D-84 at 1.

In addition, the senior manager created and sent to Laccetti and Taro USA a "pivot table by customer with the aging balances" reflected on the company's "detailed" "12/31/04 aging" report, for use in "identify[ing] aged items by customer" and "analyzing [its] A/R for adequate reserves." Exs. D-82, D-84 (February 7-8 emails); *see* Ex. L-23 at 2132-48 (table was included in the work papers); R.D. 139a at 997-98 (Laccetti). The senior manager wrote to Laccetti at the time that "the aging report show[ed] over $7 million in outstanding A/R and I have not received any answers back yet." Ex. D-85.

Late on February 8, 2005, Laccetti wrote to the principal auditor, "Our accounts receivable analysis is not favorable. We shared our analysis with [Taro USA's Vice President of Finance] last week and he asked us to do some additional analysis from [a] different p[er]spective. We have done what he requested with no change in the result." Ex. D-87 at 1; *see* R.D. 137 at 683. Further, "We have presented all of the analysis to the Company with the current position that we are not comfortable that the accounts

and 2004 Taro USA gross sales of approximately $552 million and $580 million, and attributed approximately $33 million and $55 million of these respective amounts to those branded products. Ex. D-63 at 61-62. The Audit Strategies Memorandum had noted, "As branded sales increase, the Company intends to monitor accounts receivable reserves separately for branded and generic receivables." Ex. D-72 at 6. At the bottom of the page of the 2003-2004 annual and 2004 quarterly versions of the Accounts Receivable Summary exchanged between the audit team and Taro USA, there was a "Divisional Accounts Receivable" schedule, breaking down by dollar amount and percentage, accounts receivable by generic products and branded prescription products at year end 2003 and 2004 and each 2004 quarter end. Ex. D-79 at 2-3 (annual version attached to February 4 meeting agenda); Exs. D-82 at 3-5, D-84 at 2-3 (both versions attached to February 7-8 emails); R.D. 139a at 925-26 (Laccetti).

receivable are fairly stated as currently presented. We are now asking for account level detailed analysis from the Company to support [its] position." Ex. D-87 at 1. Earlier that day, the senior manager wrote to management in this regard that: (1) it "still owes us some schedules for A/R and needs to get us detailed items that we have selected as part of our A/R testing," as well as "the A/R rollforward for the period September 30 – December 31, 2004"; (2) "we need some additional analysis to be comfortable that there are adequate [accounts receivable] reserves"; and (3) this was one of two issues about which "[w]e are especially concerned" in the audit. Ex. D-86 at 1, 2.

At the February 11, 2005 closing meeting for the Taro USA audit, attended by Laccetti and the Israeli partner, company management attributed the "lack of order" in providing support for the required level of reserves to "the drop in sales in Q2." Ex. D-91 (Israeli partner's notes); Ex. D-234 at 2 (translation from Hebrew). The partner had called that sales drop to Laccetti's attention in the engagement instructions (Ex. J-26 at 3, 6), and Lacetti had also noted it in audit planning (*e.g.,* Ex. J-29 at 7 (Internal Control and Fraud Considerations form: Taro USA's sales "have decreased dramatically in the second quarter of 2004" due to 2004 "change in the company's discount policy")).

Regarding next steps, Taro USA was "supposed to prepare a list of supporting calculations that will be examined by Ernst & Young, and the reserves will be updated accordingly. Among the documents there will be correspondence with the customers." Ex. D-234 at 1 (Israeli partner's February 13, 2005 notes of discussions with Laccetti). Also, "there is an aging report according to which the balances were examined and, with regard to customers of over one year, explanations will be given. In addition, the sums that were collected during January will be examined." *Id.* at 1-2. As to the aging report, on February 8, 2005, Laccetti had stated he was "now asking for account level detailed analysis from the Company," and his notes of the discussion of "A/R" with Taro USA at the February 11, 2005 audit closing meeting included a reference to "Doing detailed analysis." Ex. D-87 at 1; Ex. D-88 at 3; *see* Ex. D-84 at 1; Ex. D-82 at 1; Ex. D-85 at 1.

On Tuesday, February 15, 2005, Laccetti was still "waiting on some open items from Taro [USA] which we are expected to receive on Thursday," which included "getting more tangible support and comfort with net accounts receivable." Ex. J-22 (senior manager's email to principal auditor). It remained for the Ernst & Young audit team to decide if the additional material "meets our expectation," to "complete our analysis," and to determine if the team was "satisfied with the results." *Id.*

The audit team later communicated to the principal auditor that "timely preparation of reserve schedules were not given to us in a timely manner, delaying the timing of our audit procedures." Ex. J-25 at 2. The team also explained that Taro USA never "prepare[d] a specific chargeback estimate" or "a detailed calculation to support the allowance for chargebacks at 12/31/04," as it ultimately did for the other allowances. Ex. L-22 at 20, 22. While the team used the calculations to "audit[ ] each of the other A/R reserves independently," the chargeback reserve was left to be "audited as a component of the A/R allowances in total." *Id.* at 20. Taro USA never supplied the planned analysis of cash collections as a percentage of gross accounts receivable, only data on cash collections as a percentage of gross sales. R.D. 135 at 372 (Laccetti).

On February 17, 2005, Laccetti still did not know "where we stand" on accounts receivable reserves. Ex. D-253. But he directed the senior manager to "[d]raft the SRM right now with the a conclusion that AR reserves ok," pending "final AR analysis," because "we should be in a position to issue at least a Draft of the SRM to Israel with an e-mail laying out whatever is open," which is "the best we can do." *Id.*

The February 18, 2005 draft Summary Review Memorandum expressed the unqualified conclusion that "the net accounts receivable is fairly stated." Ex. J-6 at 4. But when, the next day, the principal auditor's engagement partner asked whether, in light of "no additional reserve [having been] recorded in regard to A/R," Laccetti was "completely satisfied with the existing level of reserves" and had "received all supporting evidence," the Israeli partner did not believe he received "a clear yes." Ex. D-100 at 2; R.D. 140a at 1284-85. Before answering, Laccetti had written the senior manager, observing, "AR is tough, but I think we are coming out OK," and received the response, "With respect to A/R – I think we are as comfortable as we can get, and we summarized that in the SRM." Ex. D-256 at 1; Ex. D-98. On February 21, 2005, Laccetti wrote to the Israeli partner, "We summarized in the SRM how we went about getting comfortable with the AR. Due to the fact that the Company can not give us lag reports related to subsequent cash receipts or accounts receivable allowances and the fact that they have no formal methodology to test, it is difficult to review appropriateness of allowance without looking at trends and specific accounts. Not considering the WAC [receivable] of $11 million and [a] $20 [million special reserve not in question here], based on the information we reviewed, we believe the AR is OK." Ex. D-100 at 2.

Under the circumstances, the Israeli partner asked Laccetti to supply certain additional documentation and to participate in a conference call "to discuss again" accounts receivable reserves and another "problematic" issue. Ex. D-100 at 1; *see* R.D. 135 at 444 (Laccetti testified he, too, understood the accounts receivable reserves issue to be "problematic"); R.D. 139a at 936-38.[7/]

[7/] The Israeli partner convened the conference call on February 23, 2005, the day before Taro USA's parent company planned to issue a press release disclosing its 2004 financial results, and the call lasted for up to two hours. *See* R.D. 180 at 55-56 ¶ 179 (citations). Participating were Laccetti; the engagement partner and the audit manager on the parent company audit; and the senior and junior foreign filing reviewers (respectively, a principal at Ernst & Young, who also advised on accounting- and SEC-related matters as a member of the firm's Capital Markets Group and served as independent reviewer on the 2004 Taro USA audit, and a senior manager at the principal auditor), who were responsible for reviewing Taro's Form 20-F filing for

D. In Response to the Audit Difficulties, Laccetti Assessed the Reasonableness of the Chargebacks Allowance Not Individually, Like the Others, But as Part of Total Accounts Receivable Allowances.

Laccetti participated in preparing and reviewed work papers, including summary memoranda, that purported to record the Ernst & Young audit team's work on Taro USA's revenue recognition, accounts receivable, and accounts receivable allowances for 2004. Two of the memoranda—one on accounts receivable allowances and one on revenue recognition—were completed by February 24-25, 2005, when Laccetti released them to the principal auditor. Ex. J-07; Ex. D-109; Ex. D-112; Ex. D-113. A third—on accounts receivable—overlapped somewhat with the first, and supplied the entire discussion of "Accounts Receivables and Net Sales" in the Summary Review Memorandum released to the principal auditor in draft on February 18 and in final on April 11, 2005. Ex. J-6; Ex. J-9. That last memorandum also included a short succeeding section on "Allowances and Accrued Liabilities." According to the engagement instructions and to forms Laccetti signed, this document's role included providing a "brief discussion of each important accounting and auditing issue," "describ[ing] the results of [the] audit procedures," and "summariz[ing] important audit results and conclusions." Ex. J-26 at 15, 22; Ex. D-126; *see* R.D. 135 at 235-38.

The Revenue Recognition Memorandum stated the following understanding of Taro USA's estimation of sales adjustments and related reserves: Taro USA created "[p]rovisions for sales discounts, and estimates for chargebacks, rebates, damaged product returns, and exchanges for expired products" as a "reduction of product sales revenues at the time such revenues are recognized," which are management's "best

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compliance with US GAAP and SEC requirements, in accordance with *American Institute of Certified Public Accounts, SEC Practice Section Manual, Member Firms with Foreign Associated Firms that Audit SEC Registrants*, Appendix K, Section 1000.45 (as incorporated in PCAOB interim quality control standards through Board Rule 3400T(b)). *E.g.*, R.D. 137 at 556, 675-76, R.D. 139a at 968, 979-80 (Laccetti); *id*. at 1031 (Israeli partner); R.D. 140a at 1188 (audit manager). No documentation of the discussion has been offered, and, when questioned in connection with this case, no participant could remember much, if anything, about the substance of the discussion. *E.g.,* R.D. 135 at 444-45 (Laccetti); R.D. 140a at 1253, R.D. 142 at 1826-27 (Israeli partner); R.D. 140a at 1189-90 (audit manager: on "the subject of accounts receivable," the conversation "principally concerned" the $20 million special reserve), 1216-17, 1222-23; Ex. L-183 at 3, 4, 21 (junior reviewer's investigative testimony, also referencing special reserve). The Israeli partner and audit manager testified that by the call's end they believed they had the comfort needed to give "negative assurance" to the parent company, and, after the call, both foreign filing reviewers told the Israeli partner they, too, were not presently aware of any matters that would impact the press release. R.D. 140a at 1189-90; R.D. 141 at 1668-69, 1681-83; R.D. 142 at 1828. It issued on February 24. Ex. D-261.

estimate at the time of sale based on historical experience adjusted to reflect known changes in the factors that impact such reserves." Ex. D-63 at 5. The audit team reported that it had "completed all planned work steps related to revenue," including specified analytical procedures, two referencing sales allowances: "[c]ompare the amounts of allowance issued with those of prior periods" and "[c]ompare the current period's sales allowances as percentages of sales by product line." *Id.* at 6. There is no support that the second was done. *See* R.D. 137 at 523-26 (Laccetti). The team also stated it had performed "a detailed transaction test [of] the controls on the revenue recognition process" and "analytical procedures relate[d] to gross and net sales," but the controls testing did not encompass items that reduced gross to net revenue, and the referenced analytical procedures did not relate to net sales. *Id.*; Ex. D-63 at 5, 55-75.

The Accounts Receivable Allowances Memorandum described about a dozen separate accounts, one of which was chargebacks, provided the 2003 and 2004 year-end balance of each account, and discussed audit work on the accounts individually and in the aggregate. Ex. L-22 at 17-22. Under "Allowances and Accrued Liabilities," the Summary Review Memorandum specified that "[w]e performed procedures to test the reasonableness of [Taro USA's] estimates" for these accounts, including "accrued chargebacks," at December 31, 2004. Ex. D-125 at 3. The procedures reportedly "consisted of reviewing significant contractual terms, historical payments on Medicaid rebates, credit memo patterns, documenting [the company's] methodologies and performing analytical review procedures on [its] accruals." *Id.* at 4. Laccetti testified that the only such work that was done specifically on chargebacks was to compare the chargebacks reserve balance at the end of 2003 and 2004 and investigate unexpected changes or the absence of expected changes. R.D. 135 at 435-37; *see* D-46 at 46.

The audit team did not perform the other planned work steps for chargebacks. R.D. 135 at 366-71 (Laccetti). Rather, under those work steps, reference is simply made to the Accounts Receivable Allowances Memorandum, which stated that "the chargeback reserve was audited as a component of the A/R allowances in total." Ex. L-22 at 20. The accounts receivable work papers contained information and analysis for certain specific sales allowance items issued in 2004, but not for chargebacks. *See* Ex. L-24; R.D. 139a at 1007-09 (Laccetti). The most Laccetti could say about chargebacks data was "the submission of chargebacks is in [those] workpapers, at least in the total," apparently referring to the chargebacks line item in a schedule listing types of 2004 sales allowances next to a combined total of amounts issued in 2004 and reserved for at year end 2004 for each (Ex. L-22 at 14). R.D. 137 at 559-61; R.D. 139a at 1006-07. We interpret the statement in the initial decision that the audit team "confirmed the amounts that Taro USA had paid or credited for each sales adjustment during 2004" (I.D. 62), for which no record support is cited or apparent, as making the same reference as Laccetti, analogous to a point made in the prior paragraph of the decision about the sales allowance reserves, that a similarly summary work paper "show[s] that the [audit] team matched Taro USA's total reserves to the sum of the reserves for the individual sales adjustments" (I.D. 61).

Likewise, regarding the period subsequent to year end 2004 but before the end of the audit field work, no reference was made to a review of chargebacks, in particular. And, as to other sales allowances issued by Taro USA during that period, the work papers indicate that the audit team, without explanation, raised the planned threshold for testing, repeatedly asserting that 25% of tolerable error is $150,000 (Ex. D-46 at 44, 45, 47; Ex. L-110 at 46, 50; R.D. 135 at 367-68), when, in fact, 25% of $360,000 is $90,000. Specifically, the work papers state that the team: (1) reviewed discounts and cash returns and "noted one return greater than $150,000," which "related to 2003, and we concluded that it was properly reserved for at year end"; (2) noted "per discussion with [Taro USA] and through G/L [general ledger] inquiry, that there were no billback promotions issued in the form of a credit memo that were greater than $150,000"; (3) noted that there were no "rebate payments greater than $150,000"; (4) noted "per discussion with [Taro USA] that there have been no credits issued subsequent to year end for any indirect rebates/admin. fees"; and (5) "obtained the sales journal from 1/1/05 until 2/17/05 and reviewed for credits greater than 25% of TE [tolerable error]," and then "selected the 3 largest and agreed them" to the rebate log, "noting all accruals were great[er] than the amount per the sales journal." Ex. D-46 at 44, 45, 48, 49; Ex. L-110 at 46, 50-51, 52. At the hearing, Laccetti could not recall considering any specific chargebacks processed or recorded in connection with any subsequent events procedures. R.D. 137 at 547-50; *see* Ex. D-303 at 63-65 (senior manager on audit testified in investigation that no subsequent events review of chargebacks was done).

The Accounts Receivable Allowances Memorandum analyzed chargebacks as follows. It noted that Taro USA "did not prepare a detailed calculation to support the allowance for chargebacks at 12/31/04." Ex. D-54 at 4. Laccetti testified that Taro USA did not do so because "they looked at the chargeback allowance by just looking up the processed chargebacks, and it was difficult to identify sales and chargebacks; so they had difficulties in compiling the calculation." R.D. 139a at 1013-14. The balance of the memorandum's chargebacks analysis proceeded in this way:

> The chargeback reserve decreased by $16.27 million from prior year, while over the same period, gross trade accounts receivable increased by $11.9 million. The decrease was due to the excess chargebacks given to wholesalers in 2003 in which over $10 million was subsequently collected in 2004. Based on our procedures performed, the amount accrued at December 31, 2004 appears reasonable. As EY audited each of the other AR reserves independently, the chargeback reserve was audited as a component of the AR allowances in total. See Summary section below.

Ex. L-22 at 20, cited by *id.* at 3 (Accounts Receivable Leadsheet, 12/31/04 Audit: "Chargebacks were considered in the audit of A/R reserves as a whole.").

The “Summary” section, at the end of that memorandum, explained, “In order to test the adequacy of these reserves in total, [we] calculated [DSR] for 2004 and compared it to 2003.” *Id.* at 22, citing *id.* at 8 (work paper version of Accounts Receivable Summary schedule discussed with Taro USA on February 4, 2005). What the audit team found was that “DSR increased from 111 days in 200[3] to 171 days in 2004.” But “when we excluded over $10 million in aged AR that related to [Taro USA’s] three largest customers (who dictate payment terms due to the volume of sales they provide to [the company]) the Days in A/R were calculated at 150 days, which was in line with 2002 and 2001 DSR.” *Id.* at 22. The team concluded, “Although management did not prepare a specific chargeback estimate, based on our procedures performed above on the detailed calculations and the overall realization of accounts receivable, the allowances at December 31, 2004 appear reasonable.” *Id.; accord* R.D. 139a at 953, 1014-15 (Laccetti); Ex. L-181 at 39, 53-54 (investigative testimony of senior manager).

The work papers do not reflect any similar adjustment for the other years to make the DSRs comparable. *See, e.g.,* R.D. 144 at 2633-35 (Laccetti’s expert). At the hearing, Laccetti could not recall considering whether such adjustments should be made (R.D. 135 at 466-68, R.D. 137 at 494-95), even though the work papers attributed most of the $10 million excluded to customers who “have historically dictated payment terms, causing [Taro USA’s] days in receivable to be high” and noted that it has “a history of collecting such items” (Ex. L-22 at 5, 6). Furthermore, in making the multi-year comparison of DSRs, the audit team used substantially incorrect DSRs for 2002 and 2001, which minimized the dramatic increase: 140.26, instead of 93.14, for 2002 and 148.13, instead of 97.84, for 2001. *Compare* Ex. L-22 at 8 *with* Ex. L-24 at 172 (work paper from 2004 Taro USA audit showing DSR of 93 for 2002); Ex. D-9 (work paper from 2003 audit showing correct DSRs for 2002, 2001); Ex. D-79 at 2, 12 (data for discussion at February 4, 2005 meeting with Taro USA reflected that numbers used as net sales to calculate 2002 and 2001 DSRs were actually net sales for 2001 and 2000); Ex. D-303 at 100-03 (senior manager’s investigative testimony); *see* R.D. 135 at 469-73, R.D. 137 at 488-89 (Laccetti).

In addition to the DSR analysis, the Accounts Receivable Allowances Memorandum noted that the “total allowance for A/R reserves increased by $20.7 million from 12/31/03 to 12/31/04,” an increase from 27% to 35% of gross receivables, while gross receivables rose by $23 million. Ex. L-22 at 21. It explained that “[o]ne of the main causes of the increase in the A/R reserves” in total was the $20 million special reserve. *Id.* at 22. The work papers listed these figures and showed that total reserves as a percentage of gross receivables fell to 26% in 2004 when the $11 million excess chargeback receivable and $20 million special reserve were omitted. *Id.* at 2-3, 8.

The Accounts Receivable Memorandum began by noting, similarly, that, adjusting for the $11 million “WAC receivable” relating to the excess chargebacks and the $20 million special reserve, not in question here, gross receivables grew by $13 million from year end 2003 to year end 2004, to $166 million, whereas accounts receivable reserves rose by $1 million to $42 million. Ex. L-22 at 5. A tick mark on the 2004 Accounts Receivable Leadsheet asserted, “This was due to a combination of drop in sales for 2004 (specifically the 2nd quarter), which reduced allowances booked and a slow down in payments f[ro]m the three largest wholesalers in 2004.” *Id.* at 3. Another tick mark explained that “[r]ecovery” of “sales in the 3rd and 4th quarters,” “along with higher gross sales for 2004 increased the gross receivables” in 2004. *Id.; see id.* at 5 (memorandum references “the big decrease in sales in the second quarter of 2004,” in which the wholesalers “reduced their orders to work off their existing inventories” and observed that “[s]ales in the third and fourth quarter returned to normal levels”), 1638.

Then the Accounts Receivable Memorandum provided further detail about “our analytical review of the Days in Receivable.” Ex. L-22 at 5. It made clear that the calculation excluded the $11 million “WAC receivable” and the $20 million special reserve. And the memorandum explained that the 2004 DSR calculation had been further adjusted by subtracting the “$10 million of the outstanding A/R in over 90 days” because, “[u]pon further investigation we determined that [it] relates to items that are either advance chargebacks or duplicate rebates taken by customers that take more time and effort to collect” but that Taro USA “has a history of collecting.” *Id.* The memorandum repeated the flawed comparisons of multi-year DSRs: “the days in A/R drop down [after removal of the $10 million] to approximately 150 days and appear to be in line with the historical days percentage going back to 2002 and 2001.” *Id.* at 5-6.

Next, the Accounts Receivable Memorandum listed five items “we evaluated” to “gain some more comfort with the accounts receivable balance.” The evaluations consisted of: (1) determining, “in looking at the overall net receivable,” that “most of the aged items were in the 0-60 days category”; (2) rendering the excluded $10 million as a percentage of gross and net receivables (6%, 8%) and noting that most of it was owed by three large wholesalers who “account for a significant percentage of [Taro USA’s] sales and have historically dictated payment terms, causing [its] days in receivable to be high”; (3) describing the confirmations testing done in the audit, in which “[o]nly $2,000 of the selection [of receivables totaling $73 million] could not be verified,” and stating, “This gave us additional comfort that the client is able to collect on outstanding receivables.”; (4) computing a “three year trended days in receivable” that “was averaged at 133 days compared to the 150 days above” and attributing “[p]art of this” to the company being “shorthanded due to cut backs”; and (5) noting that management had “indicated that they were communicating with the three large wholesalers” on the “$11 million in WAC receivable relating to excess chargebacks” and “that if they are unable to receive direct payment from the wholesalers that they will reduce chargebacks or discounts given to wholesalers to eventually satisfy the receivable balance,” which was deemed reasonable since “incorrect excess chargebacks were given to the wholesalers in the first place” and “a negotiation of reduced chargebacks is a good possibility,” as “chargebacks are a normal part of [Taro USA’s] business process.” *Id.* at 6. The Memorandum also stated that “correspondence has been sent to the wholesalers to recover these [excess chargebacks] amounts” and that Taro USA "has informed us that [it is] in the process of negotiating new" general service agreements with them and "expect[s] to receive this money in 2005." *Id.* at 5.

Furthermore, the final version of the Summary Review Memorandum stated generally that, as a result of the deficiency in Taro USA's accounts receivable reserves process, "we expanded our procedures to perform detailed substantive tests of individual accounts receivable to gain comfort that the amounts were properly recorded at net realizable value." Ex. D-125 at 4. The "detailed" tests were represented by six tick marks on nine receivables, totaling $12,158,275, on a work paper reproducing Taro USA's year-end 2004 aging report, which, overall, contained 36,875 line items of receivables, consisting of $184,720,173 in open invoices and $92,076,801 in open deductions (or open debits), offset by $96,462,030 in open credits and $13,883,223 in open payments Ex. L-23 at 2, 210, 873, 1068, 1140, 1146, 1152, 1185, 1203, 1215, 2129; Ex. L-174; R.D. 135 at 415-17, R.D. 137 at 535-36.

Although not discussed in the memoranda summarizing the 2004 audit work performed, certain additional analytical procedures relating to total accounts receivable reserves were documented. They appear in a work paper version of the Accounts Receivable Summary for 2001 to 2004 that had been prepared for the February 4, 2005 meeting with Taro USA; a work paper version of the February 7, 2005 Accounts Receivable Summary for each quarter of 2004; a work paper version of February 7, 2005 Gross/Net Sales and Cash Analysis, containing the "lag analysis"; and a work paper reproducing the Cash Collections sheet prepared for the February 4, 2005 meeting and adding to it net sales and gross sales figures for 2003 and 2004 and a calculation of "% of net sales to gross sales" for 2003 and 2004. Ex. L-22 at 8-12, 15, 1640; R.D. 139a at 925-27, 1003-05; *see* R.D. 180a at 106, 110-11, 134.

E. Ernst & Young, Through Laccetti, Reported to the Principal Auditor on the 2004 Taro USA Audit, Which that Auditor Used in Issuing an Unqualified Opinion on the Parent Company's Financial Statements.

Ernst & Young reported on its 2004 Taro USA audit and expressed an opinion about Taro USA's 2004 financial data in certain submissions to the principal auditor, signed by Laccetti, for use in the audit of the parent company's 2004 consolidated financial statements. In particular, he signed and released to the principal auditor two forms used to document the results of a subsidiary audit performed at the request of another firm for inclusion in the parent company's consolidated financial statements.

The first, a Review and Approval Summary for Audit Engagements, gave a "Report Release Date" of "3/8/05." Ex. J-8 at 1; R.D. 137 at 537-38 (Laccetti). It also included representations, signed and dated April 18, 2005 by Laccetti and the senior manager on the 2004 Taro USA audit, that: the Taro USA audit team had "performed sufficient review procedures in high-risk and other sensitive audit areas to be satisfied that the detailed review was adequate and that appropriate audit recognition was given to all important financial statement amounts and disclosures"; "The audit has been planned appropriately"; "The scope of our audit is sufficient to support our report"; "The audit work has been performed in accordance with the standards of our firm and the profession"; "The significant judgments made and conclusions reached throughout the audit process were appropriate"; "All significant accounting, auditing, and reporting matters are described in the SRM or its attachments" and team members "concur with the conclusions regarding them"; and "The audit procedures achieved their purposes and the conclusions reached are consistent with the work performed." Ex. J-8 at 3-4.

The second form, a Full Scope Conclusion, signed and dated April 18, 2005 by Laccetti, stated that it "should be read in conjunction with the Summary Review Memorandum dated February 18, 2005, which describes the results of our audit procedures." Ex. D-126 at 1, 2.; R.D. 137 at 538-39 (Laccetti). This form represented that the Ernst & Young audit team performed a full scope engagement on Taro USA's 2004 reporting package, including "examining, on a test basis, evidence supporting the amounts in the" reporting package, in accordance with the principal auditor's engagement instructions, that the team "planned and performed our audit procedures to obtain reasonable assurance about whether" the reporting package was "free of material misstatement based on the tolerable error assigned by" the principal auditor, and that no unadjusted audit differences would "warrant us to revise our opinion" or "materially misstate the reporting package." Ex. D-126 at 1, 2-3.

The Summary Review Memorandum, sent to the principal auditor in draft on February 18, 2005 and in final on April 21, 2005, stated the Ernst & Young audit team's conclusion that Taro USA's "net accounts receivable is fairly stated" and, more generally, its "opinion that the scope of our audit was adequate and that the financial data of [Taro USA] for the year ended December 31, 2004 are presented fairly, in all material respects, in conformity with [GAAP], applied on a consistent basis." Ex. D-125 at 3, 11. Attached to that Memorandum was a Summary of Audit Differences, which, in final, included no adjustments relating to accounts receivable allowances. Ex. J-9 at 13.

Additionally, the Accounts Receivable Allowances Memorandum for 2004, which Laccetti approved and released to the principal auditor on February 24, 2005, concluded that, "based on our procedures performed above on the detailed calculations and the overall realization of accounts receivable, the [accounts receivable] allowances at December 31, 2004 appear reasonable." Ex. D-54 at 6. And the Revenue Recognition Memo, substantially prepared by Laccetti and sent to the principal auditor on February 25, 2005, represented that "[w]e have completed all planned work steps related to revenue"; that, "[b]ased on the related combined risk assessments and the results of the procedures in this and related areas, we believe that the procedures completed are appropriate" for "financial statement assertions [regarding revenue] and their respective combined risk assessments"; and that, "[a]s a result of completing the planned procedures, no audit differences were identified." Ex. D-63 at 5, 6.

Using Ernst & Young's audit of Taro USA and the other audit work on the parent company's 2004 consolidated financial statements, the principal auditor expressed an unqualified opinion on those financial statements. The Israeli firm's audit report, dated February 23, 2005, did not refer to the audit work done by any other firm. The report was included in the parent company's Form 20-F filed with the SEC on June 30, 2005.

F. The Parent Company Subsequently Restated Its Financial Results Due Principally to Taro USA's Erroneously Low Estimates of Chargebacks.

In 2007, Taro USA's parent company filed restated financial statements for 2004 and other periods. *See* Ex. D-219 at 4. Laccetti explained that the restatement related principally to chargeback estimates and did not involve "sales returns and price adjustments, other than chargebacks." *Id.* at 2; R.D. 137 at 633. An Ernst & Young memorandum, dated June 14, 2006 and co-signed by him, stated that, "[i]n connection with the audit of the 2005 reporting package for Taro USA and based on SEC Comment Letters [to the parent company] in late 2004 and 2005 requesting certain information regarding sales returns and price adjustments including a response from their external auditors," Ernst & Young "performed additional procedures in this area." Ex. D-219 at 2. The procedures and "additional information received from [Taro USA's] primary wholesale customers" led management and the auditors to conclude that Taro USA "did not adequately reserve for chargebacks from wholesalers" and that the parent company's consolidated financial statements for 2003 and 2004 needed to be restated. *Id.* at 2, 3. The memorandum observed, "A crucial element in estimating future price adjustments from wholesalers involves receiving or estimating the amount of [the company's] inventory maintained by the wholesalers that is subject to the risk of chargeback. Prior to 2006, Taro USA did not have specific terms in [its] contracts with the wholesalers requesting this information from the wholesalers on a periodic basis." *Id.* at 2. Lacking "this inventory at wholesaler information," Taro USA "developed internal methods of estimating [its] chargeback adjustments in prior years which were mostly analytical analysis of historical data." The restatement "reduced net revenue and the related receivables." *Id.* at 3. Taro USA's chargebacks reserve as of December 31, 2004 was adjusted from $2.37 million to $95.4 million, on a cumulative basis back to December 31, 2002, with a cumulative balance sheet effect as of year-end 2004 of $93 million and an income statement effect for 2004 of $9.8 million. Ex. D-215.

IV.

As noted, Laccetti was the auditor with final responsibility at Ernst & Young for the audit of Taro USA's financial information for the year ending December 31, 2004. The principal auditor, without reference in its audit report, used the Taro USA audit in issuing an unqualified opinion on the consolidated financial statements of Taro USA's parent company for that period. *E.g.,* R.D. 140a at 1183-86, 1286-89; *see, e.g.,* AU §§ 543.03-.04, .10-.13. In that connection, Laccetti made various representations to the principal auditor about the work and conclusions of the 2004 Taro USA audit, including that, based on performance of an audit in accordance with PCAOB auditing standards, Taro USA's 2004 "net accounts receivable is fairly stated" and its 2004 financial data "are presented fairly, in all material respects, in conformity with" GAAP. *E.g.,* Exs. D-128 at 1, J-6 at 4, 11, J-8 at 3-4; R.D. 139a at 985-88; *see, e.g.,* Ex. J-26 at 20-24 (engagement instructions); AU §§ 543.12 (providing, among other things, that, "prior to the report release date," principal auditor "must obtain, and review and retain," certain documents and information from other independent auditor to whom reference not made). As AU § 543.03 makes clear, "[r]egardless of the principal auditor's decision" about whether to make reference in its report to the other auditor, "the other auditor remains responsible for the performance of his own work and for his own report."

The charges before us against Laccetti all concern audit work he acknowledges performing or reviewing on Taro USA's 2004 "sales adjustments and related reserves in total, and for chargebacks specifically." *E.g.*, OIP ¶¶ 34, 43, 49. As to this work, the OIP alleges that he violated PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, and Rule 3200T, *Interim Auditing Standards*, by:

- failing to exercise due professional care and skepticism, in violation of AU § 150, *Generally Accepted Auditing Standards*, and AU § 230, *Due Professional Care in the Performance of Work*;

- failing to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion, in violation of AU § 150 and AU § 326, *Evidential Matter*;

- failing to assess adequately the reasonableness of certain material accounting estimates, in violation of AU § 342, *Auditing Accounting Estimates*;

- failing to perform a retrospective review of estimated sales adjustments, including chargebacks, reflected in the financial data of the prior year to determine, in light of subsequent experience, whether management judgments and assumptions relating to those estimates indicate a possible bias and thereby obtain additional information about possible management bias in making the 2004 estimates, in violation of AU § 316.64, *Considerations of Fraud in a Financial Statement Audit*;

- failing to comply with AU § 329, *Analytical Procedures*;

- failing to investigate appropriately management representations contradicted by other audit evidence, in violation of AU § 333, *Management Representations*;

- failing to evaluate appropriately credit claims processed after year end, contrary to AU § 560, *Subsequent Events*; and

- failing to take appropriate steps to assess information learned after expressing an unqualified opinion, in violation of AU § 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. *E.g.,* OIP ¶¶ 34-38, 45, 47, 69-71.

The initial decision found that the Division proved by a preponderance of the evidence that "the [audit] testing of Taro USA's total reserves was deficient," "insofar as that total reflected the chargeback reserve." I.D. 62, 71. The decision held that PCAOB auditing standards required an individual assessment of the chargebacks reserve and determined that under either that approach or the approach that Laccetti argued he had followed of auditing the chargebacks reserve as a component of total accounts receivable reserves, Laccetti failed to exercise due professional care and skepticism, failed to obtain and properly evaluate sufficient competent evidential matter, and failed to properly audit a significant accounting estimate, in violation of AU §§ 150, 230, 326, and 342. I.D. 60-74. As to Laccetti's assessment of Taro USA's ability to reasonably estimate, in accordance with GAAP, its individual sales adjustments and related reserves other than chargebacks, and his assessment of the reasonableness of those other estimates, the decision found that no violation had been proven. I.D. 61-62. Next, the decision rejected affirmative defenses asserted by Laccetti. I.D. 86-90. Determining that Laccetti's "deficient assessment of Taro USA's chargebacks reserve individually and as incorporated in Taro USA's total reserves" was reckless, the decision ordered that he be suspended from associating with any registered public accounting firm for six months and that he pay a $25,000 civil money penalty. I.D. 109-115.

Laccetti petitions for Board review of these findings of violations and of the sanctions imposed. His petition includes challenges to the hearing officer's admission, over objection, of the Division's expert witness's report and testimony, and the hearing officer's rejection of Laccetti's affirmative defenses. The Division petitions for review of the hearing officer's exclusion of certain post-audit evidence it argues is relevant to liability and sanctions. To the extent the initial decision found the Division had not proven violations regarding sales adjustments and related reserves as a whole, it seeks review of that determination. The Division also seeks review of the sanctions imposed.

Additionally, the initial decision found that a retrospective review of Taro USA's accounts receivable allowances had not been performed, in violation of AU § 316.64. I.D. 75-77. The hearing officer stated that Laccetti had been negligent in that regard and imposed no additional sanctions for that violation. I.D. 113 n. 50. Laccetti did not petition for Board review of any determinations made on the AU § 316.64 charge. The Division challenges the finding of no more than negligence and the lack of a sanction.

Finally, the decision dismissed the AU §§ 329, 333, 560, and 561 charges against Laccetti as "not proven," although it dismissed the § 329, 333, and 560 charges based largely or entirely on the view that they were "fully and more appropriately addressed" or "better considered" under the charges as to which violations were found or that AU § 560 did not apply by its terms to this case. I.D. 77-86. The Division seeks review of the dismissal of the charges brought under all four of these standards.

In summary, the Division argues, in support of its petition for review or in opposition to Laccetti's petition, that Laccetti recklessly failed to properly perform audit procedures, to adequately evaluate audit evidence, and to obtain sufficient evidence to gain reasonable assurance that Taro USA's 2004 financial reporting package was free of material misstatement, whether caused by error or fraud. More specifically, the Division contends that Laccetti violated AU §§ 150, 230, and 326 by inadequately evaluating audit evidence, and obtaining insufficient audit evidence, about Taro USA's 2004 recorded sales adjustments (or sales allowances) and related reserves (or accounts receivable allowances) in total and for chargebacks specifically. According to the Division, Laccetti needed the evidence both (1) to assess Taro USA's adherence to GAAP, in light of the company's recognition of revenue at the time of sale and consequent estimation of the amount of sales allowances it would incur based on those sales; and (2) to form conclusions about the validity of high-risk assertions of material significance relating to the $248 million in net sales (reflecting total year-end 2004 sales adjustments of $330 million, $200 million in chargebacks) and $114 million in net accounts receivable (reflecting year-end 2004 reserves of $42 million) presented in Taro USA's 2004 financial reporting package. Moreover, viewing the sales adjustments and related reserves as significant accounting estimates, the Division argues that Laccetti failed to satisfy specific requirements under AU § 342 for obtaining and evaluating sufficient audit evidence to support the reasonableness of such estimates.

Furthermore, the Division argues that Laccetti failed to comply with additional PCAOB standards governing performance of certain types of procedures, or consideration of certain types of information, relating to the sales adjustments and related reserves. According to the Division, Laccetti, operating in an environment of scant information about a large and important part of Taro USA's sales allowances and relying mainly on high-level analytical procedures:

- accepted a management representation about the 87% decrease in the year-end chargebacks reserve from 2003 to 2004 that did not make sense and conflicted with other audit evidence, contrary to AU § 333;

- employed a faulty analysis of the average number of days for payment to be made on sales—DSR—as the primary analytical procedure to test the adequacy of Taro USA's 2004 year-end accounts receivable reserves as a whole, contrary to AU § 329;

- failed to analyze the 2004 year-end reserves in total and for chargebacks by reference to certain year-end data in the work papers indicating that the reserves were materially understated, again contrary to AU § 329, such as:

    - comparing calculations appearing in the work papers of total reserves as a percentage of gross receivables (26%) to total sales adjustments as a percentage of gross sales (57%) and total gross sales, less cash collections, as a percentage of gross sales (60%); and

    - comparing the chargebacks reserve, which was less than 5% of gross accounts receivable, to a planned calculation of 2004 sales adjustments for chargebacks (processed claims and year-end outstanding estimated claims) as a percentage of gross sales (35%);

- did not consider, as had been planned, information obtained about sales allowance claims processed by Taro USA after the balance sheet date, viewed as transactions that provide additional evidence of conditions existing at that date, that affect the estimates of the reserves, and that require consideration under AU § 560; and

- failed, under AU §§ 333 and 561, to investigate, and to consider the effect on the audit of, representations by the parent company to SEC staff after the field work had ended that allegedly contradicted its earlier representations to the staff about inability to monitor and estimate inventory at wholesalers, relevant to estimating sales allowances.

In addition, the Division argues that Laccetti recklessly violated AU § 316.64 because a retrospective review of Taro USA's 2004 sales allowance estimates was not performed, despite Laccetti's knowledge that it was required, inclusion of the procedure in the audit plan, and representation to the principal auditor that it had been performed.

Overall, the Division seeks review of the sanctions imposed. It urges that Laccetti be barred from associating with registered public accounting firms, with leave to petition to associate in three years, and ordered to pay a $100,000 civil money penalty.

Laccetti, in support of his petition for review or in opposition to the Division's petition, contends that PCAOB auditing standards did not require him to specifically assess chargebacks. He argues that, through a combination of audit work on the other individual accounts receivable reserves and on the total reserves balance, he evaluated Taro USA's ability to estimate, and the reasonableness of its estimate of, accounts receivable reserves as a whole, in compliance with the standards. He also argues that the substantive analytical procedures forming part of his audit work on the reserves complied with AU § 329 and that it left the choice of such procedures to his professional judgment; that AU § 560 did not require him to review sales allowance claims processed after the balance sheet date; and that nothing came to his attention that required him to take action under AU § 561, if it applies here. Furthermore, he presses his affirmative defenses, claiming that a particular expert should have been allowed to attend his investigative testimony and that this proceeding is invalid under separation of powers principles and the taxation power of the United States Constitution. On sanctions, he contends his violation of AU § 316.64 was no more than negligent and merits no sanction. Overall, he claims that when "mitigating and contextual circumstances" are properly taken into account, anything more than "*de minimis*" sanctions are excessive.

V.

The Division bears the burden of proving the charges against Laccetti by a preponderance of the evidence. PCAOB Rule 5204(a). We apply the auditing standards as they existed at the time of the alleged violations.

There is no dispute that sales adjustments and related reserves were high-risk areas and warranted special attention in the 2004 Taro USA audit. *E.g.*, R.D. 135 at 273-74, 444 (Laccetti); R.D. 139a at 936-37 (Laccetti: "[a]ccount receivables [was] one of the highest areas" in terms of time spent in the 2004 Taro USA audit, consuming about a third of the post-planning hours, with another third devoted "to the other significant estimates and then [the rest] on the lower risk accounts"). In recognizing revenue at the time of sale, Taro USA undertook to comply with GAAP by making and recording what it deemed to be reasonable estimates of its sales allowances so as to reflect the actual amount it would collect on the sales. *E.g.*, R.D. 180 at 10 (Laccetti brief citing SAB 104). An auditor's opinion that financial data is presented in conformity with GAAP must be based on an audit conducted in accordance with PCAOB standards, and those standards require an auditor to perform audit procedures sufficient to evaluate the issuer's compliance with GAAP. *E.g.*, AU §§ 150, 326.25. Furthermore, Laccetti recognizes that, for audit purposes (*see, e.g.,* AU §§ 326.07, .13, .25, 342), Taro USA's accounts receivable allowances in total was a significant account and a significant accounting estimate whose measurement or valuation was an assertion of material significance to the financial data Taro USA reported to its parent company for inclusion in publicly reported consolidated financial statements. *E.g.,* R.D. 204 at 4.

By year end 2004, the sales allowance claims that Taro USA had processed during the year and the amount of claims it estimated were still outstanding from past sales had a combined effect of more than $330 million on the revenue it recognized from its $580 million in gross sales. Ex. L-22 at 8, 12, 14-15. In estimating, at year end 2004, the value it would realize on its $165.5 million in outstanding unpaid prior sales, net of future sales allowance claims arising from those sales, Taro USA relied on its $42.2 million accounts receivable reserves. As Laccetti knew, Taro USA's parent company made most of its reported revenue through Taro USA, the net amount the parent company reported it would realize on its outstanding receivables derived mainly from Taro USA's sales, and a high percentage of the sales adjustments and related reserves that affected those figures were attributable to Taro USA. Ex. J-1 at 34; Ex. D-278 at 3; Ex. D-294 at 1, 4; R.D. 135 at 197 (Laccetti). And Laccetti knew the principal auditor was using the work and report of the 2004 Taro USA engagement team led by Laccetti in auditing the parent company's consolidated financial statements.

Laccetti's understanding of Taro USA's process of estimating its total sales allowances and conclusion that the process itself was deficient had implications for the audit work that needed to be done with respect to the accounts receivable reserves. Yet that audit work was too general, limited, or flawed to support the estimate. Laccetti violated numerous PCAOB standards.[8/]

A. Laccetti's Understanding of Taro USA's Estimation Process for Accounts Receivable Allowances

Before addressing the audit procedures that Laccetti performed or reviewed relating to Taro USA's accounts receivable allowances, we first discuss Laccetti's understanding of, and determinations about, Taro USA's process of estimating those allowances, which informed the overall audit work that needed to be done in the area. *See, e.g.,* AU 342.10.

In planning the 2004 audit, Laccetti regarded each individual accounts receivable allowance as having its own "Calculation Process" of some sort, to be understood and tested, and stated that he planned to "[r]eview the overall reserve calculation as of December 31 and the related accounts." Ex. L-1 at 3, 5; Ex. D-15 at 3-4; Ex. D-72 at 6. The audit bore out differences in the way allowances were estimated. Ex. L-22 at 17-21. According to Laccetti's briefing in this case, Taro USA "develop[ed] an estimate of the accounts receivable allowances as a whole based on [its] management's historical experience, trends, and subjective judgments"; then Taro USA used that estimate,

[8/] The parties dispute whether PCAOB auditing standards required Laccetti "to audit [Taro USA's 2004] chargebacks specifically" or "individually," in addition to assessing its 2004 sales adjustments and related accounts receivable allowances "as a whole," in "total," or "overall." *E.g.*, R.D. 205 at 15-18, 48-50; R.D. 215 at 5-6; R.D. 204 at 4-8; R.D. 210 at 18-21. The OIP charged violations of PCAOB standards in both respects, the Division urged both positions, and the initial decision addressed both. *See* I.D. 40, 62, 71, 73, 111, 112. Laccetti does not claim that he was free to ignore the part of total accounts receivable allowances represented by chargebacks but instead that the standards allowed him to assess that part through the composite estimate of the accounts receivable allowances as a whole. *See, e.g.*, R.D. 210 at 20-21. We need not decide whether the disputed audit approach was required. The answer does not change the fundamentals of the case, such as the characteristics of Taro USA's sales adjustments and related reserves, including chargebacks, and the surrounding circumstances in which the audit work was performed, nor does it change the outcome.

along with estimates for "most of the components of accounts receivable allowances" that it based on "performing detailed calculations" for those components, to "derive[ ] the estimate for the chargeback component, for which [it] did not have a detailed calculation." R.D. 180 at 38; *accord id.* at 78; R.D. 180a at 77.

Taro USA's estimation of the individual allowances for which it made detailed calculations was thus insufficient, by Laccetti's own account, to estimate accounts receivable allowances as a whole or chargebacks. Management's inability to explain in any detail the estimation process, or to "prepare a detailed calculation" or "specific" estimate (Ex. L-22 at 20, 22; R.D. 135 at 334-35, 339; R.D. 139a at 908-10, 1013-14), for the allowances as a whole or chargebacks set those apart from the individual allowances for which this was done. Laccetti testified that "each one" of the latter "had different nuances, the calculation, as well as how [the company] went through the process." *Id.* at 916-17. That illustrates how little an understanding consisting of mere generalizations of the aspects of Taro USA's estimation methodology distinct from those individual allowances and applicable to accounts receivable allowances as a whole and chargebacks would contribute to supporting the whole or chargebacks.

Chargebacks was hardly a trivial or indistinct allowance. Ernst & Young training on pharmaceutical industry pricing, discounts, and rebates, attended by Laccetti in November 2004, emphasized the importance of chargebacks, pointing out that they represent "the single largest reduction of gross sales for most pharmaceutical and healthcare product companies." Ex. D-36 at 2, 37; R.D. 135 at 246. And so it was at Taro USA. During 2003 and 2004, the two years for which the record provides the data, Taro USA's recorded chargebacks exceeded all of its other sales allowances combined, surpassing the next largest type of allowance by a margin of four. Ex. L-22 at 14. In 2003 and 2004, respectively, Taro USA recorded about $150 million and $200 million in chargebacks out of total sales adjustments of $270 million and $330 million, on gross sales of $550 million and $580 million; the next highest sales allowance was rebates, approximately $33 million and $50 million. *Id.* At year end 2003, chargebacks stood out as the largest component of accounts receivable reserves by a more than two-to-one margin, at $18.6 million, 45% of the total reserves, and 12% of gross receivables. Laccetti's only apparent reason for changing plans and "audit[ing] [the chargeback reserve] as a component of the A/R allowances in total," rather than "independently," was that Taro USA did not supply a detailed calculation for chargebacks. *See id.* at 20, 22; Ex. L-1 at 3. The very inability to supply such a calculation reinforced the distinctiveness of that part of accounts receivable allowances.

The record indicates that Taro USA did not identify a clear methodology or approach to estimating accounts receivable allowances as a whole or chargebacks that Laccetti could readily have tested. Laccetti has cited the following general language in the Revenue Recognition Memorandum as reflecting his understanding of management's process for estimating accounts receivable allowances as a whole: "These revenue reductions"—"[p]rovisions for sales discounts, and estimates for chargebacks, rebates, damaged product returns, and exchanges for expired product"—"are established by the Company's management as its best estimate at the time of sale based on historical experience adjusted to reflect known changes in the factors that impact such reserves." Ex. D-63 at 8; *see* Ex. D-109 at 1, 3; Ex. D-112 at 1-2; *see* Ex. L-178 at 8 (virtually identical language in an April 25, 2005 Memorandum co-written by Laccetti on the $20 million special reserve).[9/]

Laccetti described the chargebacks aspect of the company's estimation process in no more detail than the more comprehensive aspect of its process, distinct from estimation of individual allowances, that he claims Taro USA used to estimate accounts receivable allowances as a whole and to develop the chargeback estimate. Namely, Laccetti testified, "My understanding was they looked at the chargeback allowance by just looking up the processed chargebacks." R.D. 139a at 1014. The hearing officer aptly described as "sketchy and extremely general" (I.D. 67) another description of Taro USA's estimation process provided by Laccetti (R.D. 139a at 907):

> Our understanding of their chargeback process, similar to most of their other accruals, is they would look at their historical experience, which would be the actual chargeback credits processed and issued, consider any trends similar to what I pointed out in the billbacks that they are one-off promotions or something along those lines. Then they would utilize that data, and in their judgment as to what they expected to issue in the future they would make an allowance for or an estimate for the allowance for chargebacks.

The same picture of Taro USA's estimation process emerges from testimony, cited by Laccetti, in which he asserted that, "[a]s we applied procedures to the allowance as a whole, we considered the chargeback and how that reserve related to the total" (R.D. 139a at 910) and in which the audit team's senior manager asserted in the investigation that Taro USA "looked at the overall AR, gross AR to the total allowances and evaluated the chargebacks historically based on that" (Ex. L-181 at 20).[10/]

[9/] The parent company's Form 20-F for 2003, to which Laccetti would have had access during the 2004 audit, used similarly general language: "We base our estimates for these sales allowances"—"product returns, rebates, chargebacks, and other sales allowances"—"on a variety of factors, including actual return experience of products returned, rebate agreements for each product and estimated sales by our wholesale customers to other third parties who have contracts with us….We conduct a review of the factors that influence our estimates periodically. When we find that actual product returns, credits and other allowances differ from our established reserves we make the necessary adjustments." Ex. J-1 at 47, 121.

[10/] Laccetti's argument that Taro USA had the same revenue recognition policy as in prior years, had been audited then by an engagement partner with "extensive

Beyond this, the record shows that, in planning the 2004 audit, Laccetti noted that Taro USA's "accounts receivable allowance estimation process" was "an area of significant subjectivity." Ex. J-29 at 6. The audit team's calculation of "Total A/R Reserve" at "12/31/2004" in a work paper cited by Laccetti (R.D. 180 at 38) was simply the mathematical sum of the individual accounts receivable reserves recorded by Taro USA at year end 2004, not an analysis of estimation methodology. Ex. L-22 at 2.

Any concerns arising from known general weaknesses and limitations in Taro USA's estimation processes, and from known stresses on those processes particular to 2004, applied with special force to its estimation of accounts receivable allowances as a whole and chargebacks. In planning the 2004 audit, Laccetti noted that "[m]anagement's estimation processes for accounting estimates have historically not been strong." Ex. J-29 at 6. Aware from auditor comments after a prior Taro USA audit that "the estimation of certain allowances and accrued rebates/billbacks are based on sales volume, promotions, and inventory levels on hand with wholesalers servicing third parties,"[11/] he knew that its agreements with wholesalers did not "give[ ] information about the stock levels at the wholesalers." Ex. D-234 at 2. In fact, the 2003 audit team, including Laccetti, had tried to obtain such information from Taro USA, without avail, prompted by a major pharmaceutical company's recent restatement due in part to improper revenue recognition based on estimates relating to inventory at wholesalers. *See* Ex. L-180 at 27-28, 32-34; R.D. 180 at 18 ¶ 45. That year, the team increased the combined risk assessment for Taro USA's valuation assertion of accounts receivable allowances from moderate to high, and Laccetti carried this over to the 2004 audit. Ex. D-3 at 8; Ex. D-72 at 9. Again to no avail, he asked Taro USA during that audit for data

experience and expertise regarding both the industry and the client," whose work underwent high-level review by an experienced independent reviewer at Ernst & Young, and "had not had any revenue recognition issues in the past" (R.D. 180a at 167-68; R.D. 180 at 71) does not show that the auditors in those prior years knew anything more, or more favorable, about Taro USA's estimation process than Laccetti, nor does it address the circumstances particular to the 2004 audit. *See, e.g.*, I.D. 112 n.48. The statement in AU § 342.09 that an auditor "normally should consider the historical experience of the entity making past estimates as well as the auditor's experience in the industry" requires consideration on the auditor's own part and does not mean simply deferring to a prior audit report, no matter how esteemed its pedigree may be.

[11/] Ex. J-27 at 4; *see* R.D. 137 at 797-99 (Laccetti); *see also* Ex. J-1 at 15, 47 (Taro USA's parent company's Form 20-F for 2003) ("We base our estimates for [our] sales allowances on a variety of factors, including…estimated sales by our wholesale customers to other third parties who have contracts with us. Actual experience associated with any of these items may differ materially from our estimates.").

on wholesaler inventories, according to investigative testimony he cites of the senior manager. Ex. L-181 at 21-25.[12]

Furthermore, Taro USA did not provide Laccetti with a promised "analysis of the overall realization of [its 2004] accounts receivable (cash collections as a percentage of gross accounts receivable)" (Ex. D-72 at 6). R.D. 135 at 314, 372. Nor could it provide "lag reports related to subsequent cash receipts or accounts receivable allowances." Ex. D-100 at 1. An analysis of the lag between cash collections or sales allowance claims and the sales to which they related could have been used to assess collections and exposure to future claims based on past sales. Laccetti knew that, "[i]n some instances," Taro USA had difficulty matching credits with actual invoices, could not "in all cases" produce reports to match sales with allowances, and, in particular, did not compile a detailed calculation for the year-end 2004 chargebacks reserve because, according to management, "it was difficult to identify sales and chargebacks." R.D. 135 at 210, 443; R.D. 139a at 1013-14. Indeed, Taro USA overpaid millions of dollars of chargebacks in the six months or so since July 2003 because those credit claims had not been matched to the sales generating them. And it had explained to Laccetti that the cause of the "lack of order" in providing support for the reserves during the 2004 audit was "the drop in sales in Q2" 2004. Ex. D-234 at 2. The principal auditor had identified this "substantial decrease in sales" to Laccetti as a "material change in business" and "change[ ] in significant accounting and audit issues" from 2003, and Laccetti viewed the sales drop as "dramatic[ ]." Ex. J-26 at 3, 6; Ex. J-29 at 7.

As Laccetti also knew, the auditors commented in connection with the 2002, 2003, and 2004 audits that Taro USA lacked "a formalized process for the preparation

[12] Indicating additional limitations on Taro USA's estimation of the allowances, the parent company's December 2004 response to SEC staff stated that, "[w]hile we do monitor third-party data as to prescriptions written, historical experience leads us to believe that such data is not indicative of what our customers' purchase orders will be" and it "is the only" data "that we generally utilize" from external sources such as end-customer prescription demand or third-party market research data comparing wholesaler inventory levels to end-customer demand. Ex. D-44 at 3-4; *see* Ex. D-261 at 3 (Taro USA February 24, 2005 press release indicating use of prescription data to broadly gauge trends in its direct sales). The mid-2005 supplemental response continued to indicate that the parent company made no more than limited, high-level use of prescriptions data in estimating sales allowances. *See* Ex. D-294 at 5 ("Based on our analysis of third party data indicating the continued increase in the number of prescriptions filled with our products and the increase in the number of units sold by wholesaler customers (as they were submitted to us), we viewed the reserve levels at the end of [2003] to be adequate."). The only reference to such data in the audit testing of Taro USA's 2004 accounts receivable reserves appeared in a memorandum (Ex. L-178) about the $20 million special reserve not in question here.

and review" of accounts receivable allowances that would "facilitate a more timely and accurate calculation of these accounts as well as provide consistent application from period to period"; that "would establish a consistent method of determining the allowances and also assist management in providing monitoring information for review and control of the accounts receivable"; and that "would provide a basis for monitoring customer trends and performance by line of business as well as monitor the effectiveness of the Company's credit and collection practices." Exs. J-25 at 3, J-27 at 4, D-18 at 2, D-21 at 3 (post-audit letters from the auditors to management); R.D. 135 at 217-19, R.D. 137 at 799-801, 807-08, R.D. 139a at 954-56, 975-76, 1050, 1064-65 (Laccetti); R.D. 141 at 1447-49 (principal auditor's engagement partner).

Conditions reached the point during the 2004 audit that Laccetti elevated Taro USA's lack of a formalized process to a deficiency that needed to be communicated to the audit committee as a reportable condition. This was despite management representations to the auditors after the 2002 and 2003 audits, known to Laccetti, that there were monthly and quarterly reviews of all reserves and "constant communication" between finance and accounting staff and the sales and marketing department (Ex. J-27 at 4) and that the company "is documenting a formal policy for a number of items," including "accounts receivable reserves" (Ex. D-21 at 3). As a result of the process issue, the Taro USA audit team did not rely on internal controls testing to assess the allowances. The final Summary Review Memorandum for the 2004 Taro USA audit, approved by Laccetti, stated that Taro USA's "accounts receivable reserve estimation methodology has not been defined and monitored for the most updated trends" and that the audit team had to "expand[ ] our procedures" to try to compensate for the deficient process and "gain comfort that the amounts were properly recorded at net realizable value." Ex. R-7 at 4. During work on the 2004 audit, Laccetti was highly critical of Taro USA's estimation process for accounts receivable allowances, variously writing that the company had "a lack of process for establishing an AR reserve," "no formal methodology to test," "no process for creating an estimate," "no method[o]logy or process for making a sound estimate of AR allowances," and "no real basis for the amounts they record." Ex. J-5 at 1; Ex. D-100 at 1; Ex. D-114 at 1; Ex. D-116 at 1. Although Laccetti noted in one of these same emails that the audit team "did receive some information [from Taro USA] late in the process" (Ex. D-116 at 1), the auditors never received any "detailed calculation" or "specific" estimate for accounts receivable allowances as a whole or for chargebacks during the 2004 audit.[13/]

[13/] Whether, as Laccetti argues generally, lack of a formalized estimation process was "'quite common'" at the time, before wider implementation of "the sweeping internal control reforms that were ushered in with the Sarbanes-Oxley Act of 2002" (R.D. 204 at 3), is not the issue. We reject, as did the initial decision, any argument by the Division that "informal and undocumented procedures" must be "equivalent to unreliable procedures, or, indeed, to no procedures at all." I.D. 25. Rather, the issue is that the particular discussions in the record by or known to Laccetti about Taro USA's lack of a

Given these circumstances, there can be no doubt that Laccetti's understanding of, and determinations about, Taro USA's deficient estimation process for total accounts receivable allowances heightened the rigor demanded of the overall audit work on management's ability to estimate and on the estimate's reasonableness.

B. Analysis of the Audit Testing of the Accounts Receivable Allowances

PCAOB standards require an auditor to obtain and evaluate, with due professional care, including professional skepticism, sufficient competent evidential matter to form conclusions concerning the validity of the individual assertions embodied in the components of the financial statements (or here a financial reporting package) and to support significant accounting estimates in an audit of financial statements. *E.g.*, AU § 150, 230, 326, 342. Based on an understanding of how management developed the estimate, the auditor should review and test that process, develop an independent expectation of the estimate to corroborate the estimate's reasonableness, or review subsequent events or transactions occurring prior to completion of fieldwork to identify and evaluate the estimate's reasonableness or key factors or assumptions used in its preparation, or use a combination of two or all three of these approaches. AU § 342.10.

The procedures adopted by the auditor "should be adequate to achieve the auditor's specific objectives" and reduce to an acceptable level the risk that a material misstatement may go undetected. AU § 326.13. Management representations are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for the audit opinion. AU § 333.02. Analytical procedures are "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data," and "involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor." AU § 329.02, .05. Expectations developed in analytical procedures used as substantive tests during the audit "should be precise enough to provide the desired level of assurance" that differences from that expectation that may be potential material misstatements would be identified. AU § 329.17. Expectations "developed at a detailed level generally have a greater chance of detecting misstatements of a given amount than do broad comparisons." AU § 329.19. For significant risks of material misstatement, "it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient." AU § 329.09.

Laccetti used a combination of procedures to evaluate the reasonableness of Taro USA's 2004 accounts receivable allowances. Consistent with his audit approach

formalized process—which, we agree with the initial decision, did not "concern[ ] merely the documentation of existing procedures" (*Id.*)—were part of Laccetti's understanding of Taro USA's estimation process, did not help support the estimates, and affected the audit work necessary to address the risk that the estimates were materially misstated.

of assessing Taro USA's estimated sales allowances by performing substantive procedures on the year-end accounts receivable reserves and not on the 2004 reductions of gross to net sales, the audit work at issue concerns those reserves (or allowances). As summarized at the end of the Accounts Receivable Allowances Memorandum, "[a]lthough management did not prepare a specific chargeback estimate, based on our procedures performed above on the detailed calculations [that Taro USA did provide for the other individual sales allowance reserves] and the overall realization of accounts receivable, the allowances at December 31, 2004 appear reasonable." Ex. L-22 at 22. This description is consistent with the investigative testimony of the senior manager of the 2004 Taro USA audit, cited by Laccetti, that "we had done substantive procedures related to the other allowances [than chargebacks], and…we had evaluated the AR allowances in total, [and] that was how we, so to speak, got comfortable with—felt [the reserve in total and for chargebacks] was reasonable." Ex. L-181 at 53-54.

This audit work consisted of testing individual accounts receivable reserves other than chargebacks; comparing the year-end chargebacks reserve balances for 2003 and 2004 and inquiring about the change; performing analytical procedures to test the year-end total reserves balance; and considering the results of confirmation testing of certain unpaid invoices on Taro USA's interim aging report and analysis of certain receivables on its year-end aging report. *See, e.g.*, Ex. D-125 at 2-4; Ex. L-22; Ex. L-23 at 2129-30; Ex. L-24; Ex. L-110 at 46-52; Ex. L-178 at 3-10; R.D. 139a at 952-53, 1014-15.

We agree with Laccetti that, to the extent the Division contends he inadequately assessed individual allowances other than chargebacks, the Division did not address that audit work in enough detail to prove a deficiency. But we discussed above evidence of the distinctiveness of the chargebacks allowance, and Laccetti himself does not contend that the audit testing of the individual allowances other than chargebacks sufficed to evaluate the total accounts receivable reserves balance. Indeed, other than broadly asserting that "procedures performed on the components also necessarily assessed the overall reserve as well," simply because "these components were all part of the total accounts receivable reserve" (R.D. 204 at 7, 8), he offers no analysis for why or how, in the context here, the audit work on the other individual allowances supported the total. The record shows that the audit work on the individual allowances other than chargebacks, while not proven to be deficient in its own right, nevertheless did not contribute sufficient audit evidence for the evaluation of the rest of the total balance.[14/]

[14/] The audit testing of the detailed calculations Taro USA provided for the individual allowances other than chargebacks did not particularize how it estimated, or specifically test its estimates of, accounts receivable allowances as a whole or chargebacks. That testing showed only that, in a widely varied manner, management used certain data, allowance-specific databases, percentages or averages, one-off adjustments, and broad sales trends in estimating particular allowances for which a calculation was provided. The data included Taro USA's processed credits and sales data for

At the end of 2004, the chargebacks reserve was glaringly out of line with the prior year. Laccetti has acknowledged that, at least initially, the total reserves balance appeared inconsistent with other Taro USA financial data he considered. *See, e.g.,* R.D. 139a at 1012-13. Having not received any detailed explanation or calculation of the chargebacks reserve from Taro USA (including in its replies to SEC staff inquiries), and in light of the company's 2004 circumstances, Laccetti should have viewed the one-year 87% drop in the reserve for that major Taro USA sales allowance to only $2.37 million as casting doubt on the adequacy of the total reserves balance. Yet he accepted what to him should have been a patently unreasonable explanation for the decrease.

When planning the 2004 audit, Laccetti made the judgments to use analytical procedures as substantive tests during the audit (*see* AU § 329.09-.22) in assessing Taro USA's accounts receivable allowances; not to rely on substantive testing of income statement items as part of the testing of the company's sales allowance estimates; and not to rely on internal controls testing as to the estimates. *See, e.g.*, Ex. L-1 at 3, 6; Ex. L-110 at 46-49; Ex. J-29 at 8; R.D. 135 at 315-17, 322. In trying to move from an evaluation of the reasonableness of the individual allowances for which detailed calculations existed *(see, e.g.,* Ex. D-72 at 6; Ex. L-110 at 46-52) to an evaluation of the reasonableness of the total allowance balance, Laccetti relied heavily on substantive

estimating many of these allowances; third-party sales data electronically submitted to Taro USA by wholesalers and distributors for estimating some of them; and another company's sales data, information obtained from an outside service about prescriptions written for that company's products, and other data in estimating a special reserve, not in question here, for sales of products by the other company before Taro USA acquired those new product lines from that company in July 2004. *See, e.g.,* Ex. L-24 at 2, 3, 9, 42, 44, 77, 147, 148, 167, 169, 172; Ex. L-22 at 17-21; Ex. L-178 at 3-4, 6-7; R.D. 139a at 903-04, 911-15, 921-22. This was broadly consistent with general descriptions of the allowances prepared by Taro USA's parent company for SEC staff in late 2004 and mid-2005, in response to SEC staff comment letters on the company's Form 20-F for 2003, and copied to Laccetti. Those responses represented that management "determined the amounts to accrue and reserve subjectively, on the basis of our decades-long historical experience" (Ex. D-44 at 3); that "the substantially most determinative factor that we consider in establishing accruals and reserves is our historical experience" (*id.*); and that "we monitor the inventory in the [distribution] channels based on customers' orders, customers' submissions of their sales to third parties, third party reports of prescriptions written, third party sales data, and our experience and historical data, including the amounts and levels of actual returns and rebates" (Ex. D-294 at 6). As with the audit review and testing of Taro USA's process of developing each sales allowance estimate for which a detailed calculation was provided, analytical procedures performed on those estimates provided information particular to them. *See, e.g.,* R.D. 204 at 7-8. And the audit work on subsequent events in the allowances area tested only the largest product return and the three largest rebates. *See* p. 20 above.

analytical procedures, in the form of trend analyses, to test the total. In doing so, he was hampered by Taro USA's lack of identification of a clear methodology or approach for estimating accounts receivable allowances as a whole and chargebacks that he could have readily tested and therefore in his ability to "independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors" to "corroborate the reasonableness of management's estimate" (AU § 342.10b, .12). Typically, he used the prior year's balance as his expectation.

Laccetti's days sales in accounts receivable—DSR—analysis was badly flawed. Instead of viewing the original analysis, showing a jump in DSR from 111 days in 2003 to 171 days in 2004, as an indication the chargebacks reserve—the only individual reserve not subject to direct, detailed audit testing—might be materially understated, Laccetti selectively adjusted the 2004 DSR downward and, without explanation, shifted the basis for comparison to 2001 and 2002. The other analytical procedures he cites are too general to bear the heavy weight placed on them to assess total reserves.

Finally, the evidence about the audit testing or analysis of the aging reports does not show either how this work would have addressed the sales allowance reserves or how it reached beyond the reserves that were tested individually to the rest of the balance. In fact, the record indicates severe limitations on the ability of that work to have addressed the adequacy of Taro USA's estimation of the overall balance.[15/]

[15/] Laccetti asserts that it was the totality of the audit procedures, analysis, and evidence regarding Taro USA's 2004 accounts receivable reserves as a whole that formed the basis for his conclusion that the total reserves balance appeared reasonable. R.D. 204 at 6-7 & n.10; R.D. 210 at 18, 21 & n.18. Nonetheless, Laccetti's own statements and arguments concede the importance of the analytical procedures in the mix. *See, e.g.,* R.D. 210 at 18 (Laccetti's brief chose to summarize the audit work on the reserves as follows: the audit team "deci[ded] to evaluate the overall reserve as the significant accounting estimate," "performed procedures on the components of the overall reserve," and "performed analytical procedures on the reserve as a whole"); R.D. 204 at 8 (other than audit "analyses of individual components of the accounts receivable reserve" and the Taro USA "divisional analysis," discussed above, Laccetti's brief specified "several analytical procedures" in support of the accounts receivable allowances as a whole); R.D. 180a at 203 (Laccetti argued that, as distinct from "assess[ing] the objective data [the company] used in developing the estimates of various components of accounts receivable allowances," it was "through the performance of several analytical procedures" that he "developed an independent expectation of the accounts receivable allowances as a whole to corroborate the reasonableness of management's estimate, thus assessing both the subjective and objective factors used to develop the estimate," as required by AU § 342.04); Ex. D-100 at 1-2 (citing Taro USA's inability to "give us lag reports related to subsequent cash receipts or accounts receivable allowances" and the fact that the company had "no

1. Consideration of decrease in chargebacks reserve balance

In the 2004 Taro USA audit, the only audit testing specific to the year-end chargebacks reserve was comparing the reserve balances at the end of 2003 and 2004 and considering management's representation that the $16.3 million decrease in the reserve over that period was due to an estimated $11 million in excess chargebacks that Taro USA had mistakenly paid to wholesalers and expected to recoup. This procedure was identified in the Accounts Receivable Allowances Memorandum. That memorandum was the only work paper the audit team referenced in connection with the planned work steps for testing chargebacks reserve individually, other than the lead sheet comparing the year-end reserve balances (Ex. L-22 at 2). Ex. D-46 at 46-47. And other than the comparison of the balances, the only discussion in the memorandum about chargebacks testing was a reference that "the chargeback reserve was audited as a component of the A/R allowances in total." Ex. L-22 at 20; *see* R.D. 137 at 498-99.

The steep, one-year drop in the chargebacks reserve, coupled with a management explanation for why the reserve was nonetheless adequate that, as we discuss below, was unreasonable, based on what Laccetti knew, undermined, not supported, the reasonableness of that reserve. And this was the part of the total reserves balance about which Taro USA did not provide specific information and which was not subject to direct, detailed audit testing. These circumstances signaled "the clear need for increased care and skepticism." *Gregory M. Dearlove*, SEC Rel. No. 34-57244, 2008 SEC LEXIS 223 at *51 (Jan. 31, 2008) (SEC proceeding against auditor under Rule 102(e) of the SEC's Rules of Practice, governing appearance and practice before the Commission, for improper professional conduct), *petition denied*, 573 F.3d 801 (D.C. Cir. 2009). Laccetti's acceptance of management's representation without exercising increased care and skepticism itself violated PCAOB standards.

Chargebacks was Taro USA's single largest sales discount. Of the 49% and 57% that sales adjustments reduced its gross sales in 2003 and 2004, respectively, chargebacks alone accounted for 27% and 35% of those reductions. Ex. L-22 at 14-15. At the end of 2003, chargebacks represented 45% of total accounts receivable reserves and 12% of gross receivables, and was more than twice the size of the next largest reserve. *Id.* at 2. There was reason to expect similar results a year later. According to Laccetti, Taro USA considered "the actual chargebacks credits processed and issued [and] any trends" in estimating the reserve. R.D. 139a at 907. By year end 2004, gross sales grew by $28 million. Ex. D-63 at 62; Ex. L-22 at 14-15. Recorded chargebacks rose by 34% and constituted 7% more of total sales adjustments, which generated the reserves. *Id.* at 14-15. The gross receivables covered by the total year-end reserves increased by $12 million, which again suggested the chargebacks reserve should have

formal methodology to test," Laccetti wrote to the principal auditor that "it is difficult to review appropriateness of allowance without looking at trends and specific accounts").

risen. *Id.* at 8. The total reserves grew by $1 million. *Id.* at 2, 8. Every individual reserve increased, except for chargebacks, cash discounts (slight decrease), and two of the smallest accounts ("Accrued Expenses—Misc.," from $.7 million to $.5 million; and "Allowance for Bad Debts," from $.1 million to $.05 million). Ex. L-22 at 2, 17-21.

Yet, over the same one-year period, Taro USA's chargebacks reserve fell 87%, from $18.6 million to $2.37 million, becoming one of the smallest reserves, at under 6% of total reserves and under 2% of gross receivables. About the drop, the audit work paper containing this data stated only, "Chargebacks was considered in the audit of A/R reserves as a whole. See E Memo—AR Allowances." Ex. L-22 at 3. All the referenced Accounts Receivable Allowances Memorandum added was: "The chargeback reserve decreased by $16.27 million from prior year, while over the same period, gross trade accounts receivable increased by $11.9 million. The decrease was due to the excess chargebacks given to wholesalers in 2003 in which over $10 million was subsequently collected in 2004." *Id*. at 20. The initial decision aptly described the latter statement as cryptic, deficient, inadequate, and insupportable. I.D. 69, 71, 81, 111.

At the hearing and in his post-hearing submissions, Laccetti was unable to provide any coherent description of his understanding of that statement, and he does not address it in his briefing on appeal. *See, e.g.*, R.D. 139a at 1016-18; R.D. 180a at 82, 181. The explanation was inadequate for multiple reasons. First, it did not explain why $11 million in excess chargebacks caused the reserve to fall by $16.3 million. Second, it did not explain why Taro USA left the year-end chargebacks reserve at the level to which an error had reduced it. During the period Taro USA had been allowing the excess chargebacks, that mistake had been depleting the reserve for the rest of the chargebacks: "The Company discovered [its] mistake in the first quarter of 2004 as cash decreased and the chargeback reserve decreased." Ex. L-106 at 1 (Summary Review Memorandum for quarter ended March 31, 2004); Ex. D-72 at 5 (Audit Strategies Memorandum for 2004). As Laccetti knew, the only audit evidence of a response to this problem of an understated reserve was that Taro USA "increased accounts receivable for the entire $11 million" in estimated excess chargebacks and "also reserved the entire amount." *Id.* But, at year end 2004, it ceased recording the $11 million reserve, while maintaining the $11 million receivable. *E.g.*, Ex. D-88 at 3.

Management's reference, as reported by the audit team, to its having "collected $10 million" of other, once-disputed sales allowance claims from the wholesalers seemed to treat collectability of the $11 million receivable as though it were the same issue as the adequacy of the chargebacks reserve. Similarly, the Accounts Receivable Memorandum discussed the inclusion of the $11 million in gross receivables without any offsetting reserve, but said nothing about the decrease in the chargebacks reserve: "correspondence has been sent to the wholesalers to recover these amounts"; and management "has informed us that [it is] in the process of negotiating new General Wholesale Service Agreements with [them] and that [it] expect[s] to receive this money in 2005" and "if [it is] unable to receive direct payment from the wholesalers that [it] will reduce chargebacks or discounts given to wholesalers to eventually satisfy the receivable balance," which the audit team deemed reasonable since "incorrect excess chargebacks were given to the wholesalers in the first place" and "a negotiation of reduced chargebacks is a good possibility," as "chargebacks are a normal part of [the US subsidiary's] business process." Ex. L-22 at 5-6; *see* R.D. 180 at 73 (Laccetti argues he "obtained corroborating documentation as to the collectability of approximately $11 million in chargebacks"), citing Ex. R-12 at 3 (Taro USA management representation letter, dated February 18, 2005, stating, "We acknowledge our responsibility for the not recording any allowances or reserves on $11 million in accounts receivable that relates to excess chargeback's paid to Wholesalers in 2004. We believe this amount is fully collectible and should be received in the next year.").

Even if that discussion might be read to justify maintaining the receivable (for expected direct payments of $11 million) or reducing the reserve (for expected reductions of future chargebacks covered by that reserve by $11 million), it would not explain doing both at the same time, without any evidence that the reserve had been replenished from its initially depleted state. Viewing the $11 million that was initially added to the reserves as addressing the prospect for recouping the overpayments—as later elimination of that amount from the reserves based on the status of negotiations with the wholesalers indicated—merely addressed the collection risk associated with that particular means of satisfying chargebacks claims. It did not address the restoration of the chargebacks reserve to the level necessary to cover all of the probable chargebacks claims on sales through the end of the year under audit. If that reserve were restored to that level, it would, in theory, offset the $11 million receivable dedicated to those claims. But reducing the reserves by $11 million and including an $11 million receivable double-counted the $11 million, as Laccetti himself seemed to concede at the hearing. *See* R.D. 139a at 1020.

Furthermore, even if Taro USA recovered the $11 million—by whatever means—there was an even deeper problem with management's explanation for why the company's recorded year-end chargebacks reserve was reasonable. Laccetti, in trying to justify his acceptance of management's representation about the decrease in the chargebacks reserve, which relied on the $11 million figure, essentially contends that the $11 million reasonably approximated the amount by which the chargebacks reserve had been depleted by Taro USA's overpayments of chargebacks. But in trying to explain why he did not treat the estimates of wholesaler inventory on which the $11 million figure was based as a factor in his audit assessment of Taro USA's sales allowance estimates, Laccetti took a contradictory position that only exposes how little care and attention he devoted to the level of the year-end 2004 chargebacks reserve.

The excess chargebacks resulted from Taro USA's processing of chargebacks claims made by its three largest wholesalers at the higher price it charged them as of July 1, 2003, rather than at the pre-July 1 actual purchase price. In the quarterly review for the period ending March 31, 2004, the 2003 Taro USA audit team, including Laccetti, explained that "[a]ny inventory held at July 1, 2003 would have been purchased at a lesser price and therefore entitled to a smaller chargeback than was submitted." Ex. L-106 at 1. To estimate the amount of inventory, Taro USA obtained June 1, 2003 inventory levels at one of the wholesalers and added June 2003 purchases to extrapolate the figures to July 1, 2003; and, lacking inventory data for the other two wholesalers, it assumed that the purchases from the six months before July 1, 2003 were still in inventory and calculated the excess chargebacks based on six or, in the case of one wholesaler, only four months of sales data. *Id.*; Ex. L-107 at 1-3; Ex. D-23. Then, Laccetti maintains, Taro USA used the calculations, based on "this unreliable inventory assumption," for "the sole purpose of negotiating with wholesalers to recover the excess chargebacks Taro US had paid to them," not for the parent company's year-end financial statements. R.D. 180 at 22-23 (citing R.D. 139a at 946-47, 1016-18).

By Laccetti's account, Taro USA "worked up a rough method of estimating how much money it had overpaid in chargebacks to the wholesalers," based in part on "rudimentary sales analysis," and this "not rigorous" and "rough estimate of its overpayment of chargebacks"—the $11 million—was "crude and unsuitable for use in connection with the issues of accounts receivable estimations and revenue recognition related to Taro US's financial reporting package (and the [Ernst & Young] team's audit of that financial reporting package)." R.D. 180 at 22; R.D. 180a at 182-83, 223. Laccetti explained that the estimate was based on "mostly just sales data and assumptions of how much potential inventory might be entailed" and that "[s]ales data alone" would not be used for a reasonable estimate of the chargebacks reserve because it "[j]ust tells you how much the particular customer purchased." R.D. 139a at 946-47. Laccetti claimed he did not use the estimate in any way for purposes of testing Taro USA's sales allowance reserves during the 2004 audit. *Id*.; R.D. 135 at 345-46.

The fact is, however, that Taro USA did not use the inventory estimates and resulting $11 million figure "for the sole purpose of negotiating with wholesalers to recover the excess chargebacks" but also to explain the drop in the chargebacks reserve by year end 2004. And the fact is that, during the audit, Laccetti did not treat the $11 million figure, or the negotiations, as "unsuitable" for assessing the chargebacks reserve. Rather, they were critical to his acceptance of management's representation about the decrease in the reserve. The mere fact that the wholesalers, in ongoing negotiations with Taro USA, appeared willing to accept the "crude" and "rough" $11 million figure did not constitute an audit assessment that it reasonably approximated the amount by which the chargebacks reserve had been depleted by the excess chargebacks—an assessment Laccetti never made, despite its relevance to management's representation that the diminished reserve was adequate at year end.

Laccetti argues that, in addition to the management representation just discussed, he considered an assertion by Taro USA that the increase in its sales of branded products in 2004 affected the level of its sales allowances that year. R.D. 204 at 10. This claim is based on: (1) high-level generalities offered in his testimony that "the more branded products that [Taro USA] sell[s]," which are subject to less competition than generic products, "the fewer discounts that are needed" (R.D. 139a at 925-27); and (2) "Divisional Accounts Receivable" schedules at the bottom of the 2003-2004 annual and 2004 quarterly Accounts Receivable Summary work papers (Ex. L-22 at 8-11). The schedules broadly categorized year-end 2003 and 2004 receivables into branded and generic products, calculated that the branded category had grown from $2.5 million to $17.9 million since year end 2003, while overall gross receivables had grown by $12 million to $165.5 million, and adjusted the accounts receivable reserves at the end of 2003, 2004, and each quarter of 2004 by multiplying the amount of branded receivables by 2% and subtracting that amount from the reserves, representing the cash discounts for timely payment offered on all Taro USA sales. *Id.* Laccetti testified the purpose of the calculations was to corroborate its assertion that its sales of branded products were rising and to compare the adjusted reserves, as a percentage of non-branded receivables, at period end, to see if they were "in line." R.D. 139a at 925-26.

There is no evidence that any discussion or consideration of Taro USA's so-called divisional analysis focused specifically on the reduction in the chargebacks reserve, and Laccetti has appeared to concede as much (*see* R.D. 137 at 497-99; R.D. 204 at 10 n.13). Further, it did not analyze the growth in Taro USA's branded sales or receivables, which remained a relatively small part of total sales and receivables, in the context of other developments, to determine the overall effect, if any, on the level of the year-end 2004 sales allowance reserves, much less explain a disproportionate effect on chargebacks. As Laccetti recognized, Taro USA "did not provide a divisional analysis for the accounts receivable reserves," only breakdowns of gross sales and gross receivables into the categories of branded or generic product. R.D. 180a at 136.

Laccetti also knew that, over the same period that the divisional data showed the rise in branded sales, generic sales, which were "the biggest component of [Taro USA's] sales year over year," and were fully subject to sales allowances, held steady (were "flat"). R.D. 139a at 925; Ex. D-63 at 59-62. And he knew that total sales adjustments and related total year-end reserves for 2004 each grew, as did essentially all of the major individual reserves except for chargebacks. Ex. L-22 at 2, 8, 14. In addition, Laccetti's audit work on the $20 million special reserve, which covered sales of branded products by another company before Taro USA acquired the right to sell them in July 2004, showed that chargebacks and other allowances were offered, to some extent, on sales of such products, and to the same large wholesalers Taro USA utilized. Ex. L-178 at 3, 4; *see generally, e.g.*, Ex. J-1 at 17 (Taro USA's parent company's Form 20-F for 2003: "Even if launched commercially, our proprietary products may face competition from existing or new products of other companies."); R.D. 135 at 435-37 (2004 Taro USA audit team did not review significant contractual terms or credit memo patterns for chargebacks, *see* Ex. D-125 at 4). Thus, even if there were evidence that Laccetti considered the divisional analysis in connection with the decrease in the chargebacks reserve, the analysis was too cursory to help explain the large decrease.

Despite cause for concern about the chargebacks reserve from his own audit procedure, Laccetti did nothing further to investigate management's explanation for the decrease. Indeed, once Taro USA told him it was "difficult" to match chargebacks to the sales giving rise to them and did not supply a detailed calculation for that reserve, he made no other attempt to specifically test the chargebacks allowance. He abandoned all other planned procedures to do so, including "[d]etermin[ing] reasonableness of reserve for chargebacks by calculating chargebacks as a percentage of sales"—which would have shown the chargebacks reserve was less than 5% of gross accounts receivable, while the amount of chargebacks as a percentage of gross sales was 35% (Ex. L-22 at 2-3, 14-15); "analyzing trend of chargebacks using the September and December aging and the most recent aging"; and "[o]n a test basis compar[ing] amounts accrued to contracts for reasonableness."[16/] Although Laccetti claimed to understand that Taro USA "looked at the chargeback allowance" by reviewing "the actual chargeback credits processed and issued" (R.D. 139a at 907, 1013-14), he undertook

[16/] We note, as a factual matter, that Laccetti does not explain his abandonment of the planned procedures beyond suggesting, without explanation, that it was related to Taro USA's failure to provide a detailed calculation for its year-end 2004 chargebacks reserve; stating the general point that "changes to the audit plan as the audit is carried out is a standard occurrence"; and broadly asserting that "contrasting balance sheet ratios and income statement ratios" or "comparing processed and estimated allowances" would be "inappropriate with respect to Taro US" simply because there was not a "one-to-one predictive relationship" between them. *E.g.,* R.D. 180a at 61-62, 68, 77, 79, 80-81, 95, 183, 191, 230. The last point is inconsistent with other positions taken in the 2004 audit. For example, the work papers show that, in testing Taro USA's year-end 2004 returns reserve, the audit team "reviewed the calculation and performed analytics noting that the allowance for returns as a percentage of gross sales is 2.08% for 2004 and 1.37% for 2003," which is "consistent as a percentage of gross accounts receivable." Ex. L-24 at 2. Moreover, Laccetti has repeatedly asserted that Taro USA relied on "processed sales adjustments" in establishing individual accounts receivable reserves, including chargebacks, and that the team "reviewed processed credits as part of [its] testing" of the other individual reserves. *See, e.g.*, R.D. 139a at 896-907; R.D. 180 at 38-39; R.D. 180a at 169. According to him, "processed credits during the year under audit are relevant historical information for evaluating an estimate, as they may be the most indicative of the current operating environment." *Id.* at 171. Furthermore, the engagement partner for the 2003 audit testified in the investigation to precedent for Taro USA itself having made "a calculation where they took the gross sales" and "the cash receipts for the year, and it showed a percentage of collections on the sales" and "applied that percentage to their outstanding accounts receivable at the end of the year to calculate what they believed was their allowance requirement." Ex. L-180 at 21-22.

no analysis of any chargebacks claims it received and processed and no assessment of chargebacks claims likely to be, or in fact, received after 2004 based on prior sales.[17]

Therefore, other than comparing the chargebacks reserve balance at the end of 2003 and 2004 and, without proper consideration, accepting Taro USA's insupportable explanation, Laccetti did nothing else to test the year-end 2004 chargebacks reserve itself. Instead, he otherwise relied on procedures performed on the accounts receivable reserves as a whole—to which we now turn—to test this part of the total.

2. Analytical procedures

a. DSR analysis

The Division contends that the days sales in accounts receivable—or DSR—analysis was "the primary procedure" that Laccetti used to test aggregate accounts receivable allowances and was grossly deficient. *E.g.,* R.D. 205 at 7, 23. Laccetti counters it was only one of "several" analytical procedures he used for that purpose, but otherwise does not appear to try to defend it on appeal. R.D. 204 at 6. Regardless of the parties' characterizations, the evidence shows that the DSR analysis played an important role in the 2004 Taro USA audit and that it was seriously flawed.

[17] Laccetti cannot dismiss as irrelevant to this case, as he seems to do (*e.g.,* R.D. 210 at 13 n.9; R.D. 180a at 101; R.D. 180 at 10-11), the amount of chargebacks claims Taro USA processed in 2004, because it could well have had implications for the adequacy of the year-end chargebacks reserve. He argues (*id*.) that as Taro USA approved sales allowance claims over the course of the year, it replaced, for purposes of its income statement, the estimated sales adjustments corresponding to those claims with the actual amount of the claims, and, for purposes of its balance sheet, discharged the actual amount of the claims from the appropriate reserves, with the result that by year end, only the sales allowance reserves and a related, relatively small portion of the year's total sales adjustments constituted estimates of future sales allowance claims based on past sales. But Laccetti did not analyze the relationship between processed chargebacks and future chargebacks in the 2004 audit. Similarly, Laccetti understood during the audit that Taro USA did not have inventory information from the wholesalers, did not match chargebacks claims to the sales giving rise to them, did not determine the lag time between the sales and the claims, and did not prepare any detailed calculation, based on processed chargebacks, of the expected amount of future chargebacks. In light of this lack of audit testing and evidence, Laccetti had no basis for simply assuming that the chargebacks processed in 2004 derived only from 2004 sales and largely exhausted the chargebacks that could be expected to arise from the 2004 sales, rather than foreshadowed that a large magnitude of such chargebacks was still to come.

Other than noting the amount by which Taro USA's year-end 2004 accounts receivable reserves had increased, in dollars and as a percentage of gross receivables, and explaining the increase by reference to the $20 million special reserve, all the Accounts Receivable Allowances Memorandum stated about testing the aggregate reserves was that, "[i]n order to test the adequacy of [the accounts receivable] reserves in total, EY calculated Days Sales in Receivables (DSR) for 2004 and compared it to 2003," then adjusted the DSR downward and deemed it in line with 2001 and 2002. Ex. L-22 at 22. Laccetti recognized that DSR could be an "indication of concerns with reserves." R.D. 139a at 924. Use of DSR to test the reserves is consistent with his expert's description of that analytical procedure as "utiliz[ing] relationships between net accounts receivable (accounts receivable less accounts receivable allowances) and net sales (sales less sales allowances)," such that, "[i]f, for example, chargebacks were under-reserved or actual chargebacks increased, the DSR calculated would increase." Ex. L-179 at 34. But, as his expert stated, the procedure "begins with the expectation that the DSR would remain consistent over the period of review." *Id.*

What the original DSR analysis showed was that from the end of 2003 to the end of 2004 DSR rose sharply from 111 days to 171 days. Ex. L-22 at 8. The 60 extra days extended DSR by 54% and was, in itself, the longest period specified in Taro USA's billing terms for customers to pay invoices. Ex. L-175 at 4 ("Sales/AR/Cash Receipt Narrative Process" Memorandum prepared in 2004 Taro USA audit stated, "Billing terms for the customers vary between 30 to 60 days"). Laccetti concedes the large increase in DSR was cause for concern and was part of the "problems" that led to his initially expressed discomfort with the reserves and to his view that "the trends didn't appear to be as we expected, which if the business doesn't change significantly you are going to assume the trends relatively remain consistent from one year to the next so that that is the expectation when you move into the audit." R.D. 135 at 466-68, R.D. 139a at 923-25, 1012-13; *see* D-303 at 137-38, 144-45 (audit's senior manager testifies in investigation he believes what gave he and Laccetti pause during February 2005 was "we were still struggling" with DSR). Additional analysis performed at Taro USA's request did not allay Laccetti's concerns, and the senior manager wrote to management on February 8, 2005, "The days outstanding are high and we need to consider if you are adequately reserved." Ex. D-84 at 1. Laccetti flagged DSR as an issue to the principal auditor in discussions around February 10, 2005, as reported in notes of that firm's engagement partner: "There is a growth in the number of days of credit and in the sum of the customer debts, but there is no corresponding growth in the various reserves." Ex. D-91; Ex. D-234 at 1; R.D. 139a at 1132-33; *see* Ex. D-86; R.D. 135 at 409-10.

Consistent with the foregoing, the Accounts Receivable Memorandum discussed the audit team's "analytical review of the Days in Receivable," followed by its "further investigation" and adjustment of the 170-day figure and comparison to 2001 and 2002, before describing five items it evaluated "to gain some more comfort with the accounts receivable balance," three of which related to the DSR adjustment. Ex. L-22 at 5-6. That memorandum provided the only discussion of the audit testing of aggregate accounts receivable reserves that was included in the Summary Review Memorandum sent to the principal auditor. Ex. D-125 at 2-4. When, upon reviewing the latter, the principal auditor's engagement partner pressed Laccetti on whether he was completely satisfied with the existing level of reserves, Laccetti referred the partner back to the Summary Review Memorandum. Ex. D-100 at 1-2; *see* Exs. L-181 at 63, 65-66, D-303 at 145-46, 157, 160 (in investigative testimony, senior manager on 2004 Taro USA audit repeatedly cited Summary Review Memorandum to explain audit conclusions).

Although these memoranda we have been discussing were summaries, it is reasonable to read them as highlighting points viewed as important, and the prominence given to the DSR analysis in them is telling. In addition, subject to further consideration, of course, the mathematical calculations for the other analytical procedures had been performed and the results reviewed by Laccetti by February 8, 2005, when he wrote, "Our accounts receivable analysis is not favorable" (Ex. D-87 at 1). R.D. 135 at 414-17; R.D. 137 at 535-36; R.D. 180a at 134. But, other than perhaps a calculation of net sales as a percentage of gross sales for 2003 and 2004 (*compare* Ex. D-79 at 7 *with* Ex. L-22 at 1640), the DSR adjustment was the only new calculation. The efforts and attention that continued to be expended on the DSR analysis, at a crucial stage of the audit, with the original fieldwork completion date already past, continued uncertainty about where the audit team stood on the accounts receivable reserves, and the February 24, 2005 date on which the parent company intended to issue a press release announcing its 2004 consolidated financial results rapidly approaching (*see* Ex. D-88 at 2; Ex. D-34 at 2; R.D. 135 at 422-23), indicates the importance attributed to DSR in the audit. The senior manager testified in the investigation that "we struggled quite a bit with accounts receivable through the tail end of the audit" and that, ultimately, other than the testing of the individual allowances, it was the recalculation of DSR and the comparison of that figure to certain prior years that was the primary procedure that gave the senior manager comfort with Taro USA's reserves. Ex. D-303 at 92-93, 103. Even without the senior manager's perspective, the record shows the DSR procedure played an important role in the 2004 Taro USA audit.

Yet basic aspects of this DSR procedure undermined its capacity to produce supporting audit evidence. First, after discussions with Taro USA (R.D. 139a at 923-25), Laccetti "determined that $10 million of the outstanding A/R in over 90 days relates to items that are either advance chargebacks or duplicate rebates taken by customers that take more time and effort to collect." Ex. L-22 at 5, 22. The only identifiable description of this determination in the work papers is a brief reference in the Accounts Receivable Memorandum and the Accounts Receivable Allowances Memorandum. There is no indication in these work papers or Laccetti's testimony that in making the determination he relied on anything other than management representations. The senior manager of the audit testified in the investigation that, while he recalled "some explanations as to the rebates being investigated based on the analysis we had done on the accounts receivable aging," he did not believe there was "specific audit evidence obtained" from Taro USA about advance chargebacks "that was analyzed and included in the work papers." Ex. D-303 at 109-110. The work papers indicated that the audit team reviewed Taro USA's 2004 year-end aging report and identified nine items, five involving its three largest wholesalers, by six tick marks on a work paper. Laccetti could not recall whether or not this work related to the DSR adjustment. R.D. 137 at 491-92. But the tick marks refer only to a billback, two rebates, and "credit amounts" of unidentified type, and, apart from one billback, do not suggest that the descriptions were supported by anything more than untested management assertions. Ex. L-23 at 2129.

Second, the audit team stated that the majority of the $10 million "related to [the company's] three largest customers," which "account for a significant percentage of [its] sales and have historically dictated payment terms, causing [its] days in receivable to be high," and that Taro USA "has a history of collecting such items." Ex. L-22 at 5-6; *see* Ex. L-23 at 2129 ("Since [the company] is dependent on three very large wholesalers…it is at a disadvantage when it comes to collecting payment timely. The wholesalers have historically been slow in paying [it]."). But these assertions provided no basis for distinguishing 2004 from prior years and identifying a cause that could allay the concern that the 2004 collection problem indicated a problem with the reserves.

Yet, third, the audit team stated it "removed these items from the [2004 DSR] calculation" and DSR "drop[ped] down to approximately 150 days," which "appear[s] to be in line with the historical days percentage going back to 2002 and 2001." Ex. L-22 at 5-6, 22. This omits to mention that the new calculation was based on a different formula than the 171 days and represented fourth-quarter 2004 DSR, which originally had been 164 days (*id.* at 10 (line 30, column I)), not annual 2004 DSR. Moreover, there is no claim or evidence that the auditors even considered whether it was necessary to adjust any prior year's DSR to exclude items comparable to the $10 million excluded for 2004. R.D. 135 at 466-68; R.D. 137 at 494-95. The audit team's point that most items on Taro USA's 2004 aging report "were in the 0-60 days category" and the $10 million excluded in 2004 "only represented" 6% of gross receivables and 8% of net receivables (Ex. L-22 at 6) said nothing about comparability to other years. And no explanation was given for shifting the comparison to other years and avoiding any direct comparison to 2003, having chosen it as a reasonable expectation for this and other analytical procedures.

Even based on the 150-day recalculation, DSR had grown by more than 35% since 2003, while total accounts receivable reserves had risen by less than 2.5% and the chargebacks reserve had fallen by 87%. Ex. L-22 at 2, 5; R.D. 180 at 86 (Laccetti acknowledges that even at 150 days, the change from 2003 was "still somewhat large"). Additionally, the senior manager had called Laccetti's attention to an analysis showing that DSR continued to increase each quarter in 2004 and to a quarterly comparison of cash collections to gross sales, which was down to 34% by year-end, a low for the year, from around 45% the prior two quarters, and indicated to the senior manager that "the 4th quarter was not good" (Ex. D-82 at 1, 6). R.D. 135 at 403-08 (Laccetti); Ex. L-22 at 10, 12. The work papers also showed that "Days in receivable outstanding based on cash collections" had risen from 168.39 in 2003 to 191.48 in 2004. *Id.* at 12; R.D. 137

at 492-93. The audit team's "lag analysis," even "assuming [an] average of 110 days to collect receivables" based on 2003's much lower DSR, showed outstanding receivables that did not relate to the current quarter increasing by over $10 million in the fourth quarter to $48,961,234, higher than any other quarter in 2004 except the second. Ex. L-22 at 12. The team's February 8, 2005 analysis of the last five months of cash collections, post-dating the second quarter sales decline, stated that the results were "not good." Ex. D-83 at 1, 7; Ex. D-85. That analysis, not included in the work papers, showed that it would take 244.34 days to collect the year-end 2004 accounts receivable balance based on the average monthly collections for September 2004 through January 2005. Ex. D-83 at 7; Ex. D-303 at 121-26 (senior manager's investigative testimony).

Fourth, the team used incorrect DSRs for 2002 and 2001—140.26 and 148.13—that greatly overstated the real numbers—93.14 and 97.84. It is not clear why those DSRs were recalculated on a blank slate in the 2004 audit. The prior year's work papers, which both Laccetti and the senior manager stated they had consulted at some stage of the 2004 audit, and which Laccetti helped create as senior manager on the 2003 audit, contained correct DSRs back to 2001, and a 2004 audit work paper analysis of reserves and write-offs, a work step he signed off on as having reviewed, contained the correct 2002 DSR. Ex. L-110 at 44-45; Ex. L-24 at 172; Ex. D-9; R.D. 137 at 490, R.D. 139a at 882-83 (Laccetti); Exs. L-181 at 12-13, 36-37, D-303 at 110-11 (senior manager's investigative testimony). In any event, had Laccetti led a review of the audit work papers from prior years focused on whether there was a need to adjust those years' DSRs, for purposes of a valid comparison to 2004, the erroneous, off-the-cuff re-calculations of the prior years' DSRs in the 2004 audit likely would not have happened.

Fifth, the audit team stated that it had averaged the DSRs for 2001, 2002, and 2003 into a "three year trended days in receivable" of 133 days and compared it to the 150 days, with the notation that "[p]art" of the difference "was a result of [the company's] accounts receivable account analyst/customer account representatives being shorthanded due to cut backs." Ex. L-22 at 6. But the average was incorrect because the DSRs for 2002 and 2001 were each 50 days too low, due to the calculation errors. There is no indication in the record of any audit testing of Taro USA's representation about staffing or how it related to collections, nor any analysis of how much of a part it might have played in increasing DSR. It did not prevent Taro USA from "process[ing] more credits during 2004 than they did in 2003" (R.D. 139a at 931); *see* Ex. L-175 (Sales/AR/Cash Receipts Narrative Process memorandum in work papers discussing customer service staff duties). And whatever part a staffing shortfall may have played in a 17-day difference in DSR does not explain a much larger actual difference in DSR.

Thus, contrary to Laccetti's claim that the "2004 DSR supplied evidence that Taro USA's accounts receivable reserves were adequate" (R.D. 180a at 128), the faulty DSR analysis did no such thing. Similarly, he is incorrect that it qualified as "independently develop[ing] an expectation as to the estimate by using other key factors or alternative assumptions about those factors [used to prepare the estimate]" under AU § 342.10b and .12. Laccetti used DSR as an important test of the total accounts receivable reserves balance. He chose 2003 as his expectation for DSR, and then, after its DSR figure contrasted unfavorably with 2004, avoided any further examination of, or direct comparison with, 2003 in the analysis, and, without any reasoned explanation, casually substituted as his expectation the earlier years' DSRs or a "three year trended" average DSR. Relying on uncorroborated management representations, Laccetti adjusted the 2004 DSR figure downward without even considering making comparable adjustments to the other years' DSRs, where the stated reason for making the adjustments applied equally to the other years. This, as far as he knew, rendered the comparisons of DSRs he then proceeded to make incongruous, indeterminate, and unreliable.

b. Additional analytical procedures performed

In addition to the divisional and DSR analyses, discussed above, Laccetti's appeal briefs specify four other analytical procedures performed as substantive audit tests of Taro USA's 2004 "overall accounts receivable reserve" that, in his view, "supported the reasonableness" of that reserve. R.D. 204 at 6 n.10, 7-9; R.D. 210 at 18, 21. The role these four procedures actually played in his thinking during the audit is unclear from contemporaneous evidence. Although the calculations appear in the work papers, all of them except perhaps a calculation of net sales as a percentage of gross sales for 2003 and 2004 (*see* Ex. L-22 at 15, 1640) had been prepared before he wrote on February 8, 2005 to the principal auditor, and conveyed to Taro USA, that the audit team's accounts receivable analysis was not favorable. And the last three of the four are not mentioned in the audit memoranda highlighting the work performed. Laccetti testified generally that he continued to evaluate all audit data as conversations with Taro USA progressed in February 2005. R.D. 139a at 952-53. Assuming that he relied on the four analytical procedures to support his unqualified opinion on Taro USA's 2004 financial reporting package, we find that, although the procedures could have provided some information, they were too imprecise and the analysis too cursory and inconsistent with other data to provide the necessary degree of assurance, in combination with the other audit work at issue, that a potential material misstatement of Taro USA's total year-end accounts receivable reserves balance would be detected.

First, the audit team noted that, adjusting for the $11 million excess chargebacks receivable and the $20 million special reserve, Taro USA's year-end gross accounts receivable had risen by $12 million, while year-end gross accounts receivable reserves had "increased only $1 million," from 2003 to 2004. Ex. L-22 at 2-3, 5, 8, 21. The team explained the dollar amount of change in the one relative to the other as being "due to a combination of a drop in sales for 2004 (specifically the 2nd quarter), which reduced allowances booked and a slow down in payments from the largest wholesalers in 2004." *Id.* at 3. In terms of percentages, the team computed the year-end reserves as 26% of the gross in 2004, compared to 27% in 2003, *id.* at 8, from which Laccetti simply concludes that "the figures for 2003 and 2004 were closely aligned" (R.D. 204 at 9).

This first procedure thus compared the year-end gross receivables and accounts receivable reserves, in dollar amount and as a percentage of one another, for 2003 and 2004. It was a general trend analysis that did not provide any detailed study of the relationship between the year-end gross receivables and accounts receivable reserves. As to the percentage comparisons, Laccetti contends that Taro USA estimated sales allowances as a whole and chargebacks, as distinct from the other individual sales allowances, by historical comparisons of "'the overall AR, gross AR to the total allowances.'" R.D. 180 at 38 n.15 (quoting senior manager's investigative testimony). If so, then an audit procedure making similar comparisons amounted to little more than replicating management's calculations, without testing or evaluating its methods.

Further, Taro USA's sales allowances were many and varied, as were the ways it derived the estimates for them. This first analytical procedure was a highly aggregated comparison that did not identify or provide insight into potentially significant changes in different types of allowances or explain data obtained by the audit team about particular allowances. For example, from year end 2003 to year end 2004, the rebates reserve rose by $7.9 million to $19.6 million, an increase of 149%, from 5% to 12% as a percentage of total accounts receivable reserves. The Accounts Receivable Allowance Memorandum had noted that "[i]n the second quarter of 2004, Taro moved from issuing rebates on a monthly basis to a quarterly basis with the exception of three customers." Ex. L-22 at 18. Evidently, this was a reversal of practice from 2003, with potentially serious implications for assessing the total reserve balance. The Summary Review Memorandum for the 2003 Taro USA audit, co-signed by Laccetti as senior manager, had explained that "during fiscal year 2003 [the company] began processing rebates on a monthly basis where in past years rebates were processed quarterly," causing "a significant reduction in the rebate allowance at December 31, 2003, which has resulted in total allowances as a percentage of accounts receivable to decline significantly at December 31, 2003 as well." Ex. D-4 at 2 (introduced without objection from Laccetti, *see, e.g.,* R.D. 66a at 1; R.D. 141 at 1468-71; R.D. 174 at 16). Yet the first analytical procedure obscured, rather than identified or explained, any reverse dynamic in 2004, which might have misleadingly offset, through the procedure's gross comparisons of the amount or percentage of total reserves, the 87% reduction in the chargebacks reserve. And we are unable to find any analysis of this issue elsewhere in the work papers.

Additionally, there is no analysis of why the figures for 2003 and 2004 should have been "closely aligned," given the 2004 developments described in the work paper, or any attempt to reconcile this finding with the DSR analysis, in which 2003 results were discarded as a valid expectation for 2004 results. Even if 2003 were a reasonable benchmark, the explanation is flawed for why, by year end 2004, compared to 2003, the increase in the accounts receivable reserves was so small relative to the increase in the gross receivables: that the second-quarter drop in sales resulted in less sales deductions being added to the reserves, while sales allowance claims continued to arrive and reduce the reserves, and the slowdown in payments enlarged gross accounts receivable. No account is taken of the fact—noted repeatedly in the work papers and stressed in response to comments by the principal auditor on the draft Audit Strategies Memorandum—that there was a "[r]ecovery of sales in the third and fourth quarter," once wholesalers worked off their existing inventories, resulting in a $12 million increase in gross sales for 2004. Ex. D-72 at 3-4; Ex. L-22 at 3, 5, 12, 1638. Thus, the only reason given by the first procedure for why the rise in reserves lagged so far behind the rise in gross receivables was flawed. And Taro USA's divisional analysis did not explain any increase at all in the reserves, much less the $63 million increase in sales adjustments from year end 2003 to year end 2004. *See id.* at 14-15.

Second, for each successive quarter of 2004, the audit team compared the total accounts receivable reserves as a percentage of gross accounts receivable: 19%, 28%, 30%, 26%. *Id.* at 10. Laccetti asserts (R.D. 204 at 9), without explanation or citation, that this "supported the reasonableness of the overall accounts receivable reserve."

Again, this was a broad, highly aggregated comparison. The rising percentages over the course of the year until the fourth quarter and the decline that quarter to around the second-quarter level, still close to the third quarter-level and well above the first, is not consistent with the description of 2004 developments provided in the first procedure. This casts even further doubt on the validity of those descriptions or on the value of the broad comparisons of total balances of accounts receivable reserves and receivables. Moreover, if Laccetti is suggesting that the quarterly procedure shows consistency of the reserves from quarter to quarter, Taro USA used the same methodology throughout 2004, according to Laccetti (*see* Ex. D-72 at 5), so the reserves could have been consistently incorrect. Also, Laccetti wrote in his March 3, 2005 email to the principal auditor that "I believe we did receive some information [from Taro USA] late in the audit process," and "[t]hey do book allowances through-out the year," but "they have no real basis for the amounts they record." Ex. D-117 at 1. There is no indication this problem would have been remedied as to accounts receivable allowances as a whole and chargebacks, for which no detailed calculations were provided during the audit. Under these circumstances, the sequence of quarterly reserve percentages is unrevealing.

Third, splitting gross sales in two different ways, Laccetti compared net sales as a percentage of gross sales for 2003 and 2004—51% and 43%—with cash collections as a percentage of gross sales for those years—43% and 40%. Ex. L-22 at 15, 1640. Explaining that the more closely net sales approximate cash collections, the more exact is a company's accounting estimation of the amount of cash it will realize from its sales, Laccetti testified that he "took comfort" from the fact that "the gap" between the percentage of gross sales comprised by net sales and the percentage of gross sales comprised by cash collections "was closing" from 8% (51% minus 43%) in 2003 to 3% (43% minus 40%) in 2004. R.D. 139a at 930. In a related calculation, the team looked at the relationships from the other side of the coin. The part of gross sales not comprised by net sales is sales adjustments, and the part of gross sales not comprised by cash collections is uncollected gross sales. Dividing these other components of gross sales by total gross sales, the team calculated an "Allowance percentage based on net sales" and an "Allowance percentage based on cash collections," showing that sales adjustments had risen from 2003 to 2004 by a greater percentage (49% to 57%) than uncollected gross sales had risen (57% to 60%), as a percentage of gross sales. Ex. L-22 at 15. The work paper stated that "the allowance percentage for net sales and cash collections increased" due to "price erosion in 2004" and that cash collections were down "due to decrease in net sales in 2004 and slow down in payments from three largest wholesalers." A tick mark linked the figures showing the decrease in net sales as a percentage of gross sales from 2003 to 2004 to the statement, "Due to decrease in second quarter sales in 2004 and price erosion on generic drugs in 2004." *Id.*

Although, in concept, such an analysis could be useful, this third procedure did not determine with any precision the extent to which net sales related to collections on receivables. As Laccetti noted, Taro USA did not supply an analysis of cash collections as a percentage of gross receivables or lag reports for subsequent cash receipts or for accounts receivable allowances. Ex. D-100 at 1; R.D. 135 at 314, 372. The lack of such analysis and reports indicates that the cash collection balances could tell the auditors when cash was collected but not when the related sales took place and not whether all sales allowances had been claimed on the sales. Yet the third procedure's evaluation of the "gap" between net sales and collections stopped at comparing the percentage gap year over year. No effort was made to understand the components of the gap and the reason for the change between periods. *See* AU § 329.18 ("More effective identification of factors that significantly affect the relationship is generally needed as the desired level of assurance from analytical procedures increases.").

Indeed, the third procedure's focus on comparing the gap between two sets of percentages in 2003 with the gap between them in 2004, failed to address the changes from 2003 to 2004 in components of each set of percentages—sales adjustments, net sales, and cash collections—even assuming, contrary to the DSR analysis, that 2003 was a reasonable expectation. Specifically, it failed to address the 8% increase in sales adjustments as a percentage of gross sales, compared to only a 3% increase in uncollected gross sales as a percentage of gross sales, from 2003 to 2004; the $7.7 million drop in cash collections, $35 million drop in net sales, and $63 million jump in sales adjustments, on a $28 million increase in gross sales, from 2003 to 2004; and the nearly $16 million drop in cash collections from the third to the fourth quarters of 2004, on only about a $1 million decrease in sales (Ex. L-22 at 2-3, 8, 10, 15, 1640). Although a work paper for the third procedure, certain other work papers, and Laccetti's testimony purport to discuss this, the explanations raise serious questions and concerns.

The audit team stated that the drop in 2004 net sales was "primarily due to the big decrease in sales in the second quarter of 2004" (Ex. L-22 at 5), which, as noted, did not address the recovery of sales in the rest of 2004. A work paper for the third procedure attributed the drop in net sales only partly to "price erosion on generic drugs in 2004." Ex. L-22 at 15. The Summary Review Memorandum for the second quarter 2004 review, co-signed by Laccetti, newly promoted from senior manager to partner under the engagement partner, had stated: "We reviewed the sales by product for the second quarter of 2004 compared to the first quarter, noting that the decrease in sales was a result of both price erosion and a decrease in quantities sold….Even if generic trends remain low, the new branded products [the selling rights to which Taro USA acquired in July 2004] will increase sales in the second half of 2004." Ex. L-108 at 1.

In attempting to explain why Taro USA's net sales fell by $35 million, while its overall gross sales grew by $28 million, from year end 2003 to year end 2004 (Ex. D-63 at 59-62; Ex. L-22 at 8-11), Laccetti testified that "net sales is a result of processing additional allowances…if the three wholesalers were working to reduce their inventory through the channel, and additional allowances were being presented to" Taro USA, this would "reduc[e] the net sales number." R.D. 135 at 453-55. But that claim is not grounded in the record. Laccetti understood that Taro USA established revenue reductions for estimated sales allowances "at the time of sale." Ex. D-63 at 5. Indeed, the parent company publicly reported for 2003 and 2004 that, "[w]hen we recognize and record revenue from the sale of our pharmaceutical products, we simultaneously record an estimate of various future costs related to the sale," including "our estimates of product returns, rebates, chargebacks and other sales allowances." Ex. J-1 at 47; Ex. J-17 at 44. Such estimates offset both gross sales and gross receivables. According to Laccetti, "Once a sales adjustment is submitted to Taro US by the customer and processed, the estimated accrual is removed from accounts receivable allowances on the balance sheet" and "for the purposes of the income statement, the estimated sales adjustment recorded is adjusted to reflect the actual processed credit amount," so that the combination of the remaining estimated amounts, "along with actual credits, reduced gross sale[s]." R.D. 135 at 208-09; R.D. 180 at 10. Laccetti does not argue that Taro USA offered more sales allowances in 2004 than 2003; in fact, he claims the higher branded sales reduced sales allowance reserves in 2004 (R.D. 204 at 10 & n.13), and the work papers stress the halving or discontinuation of a discount that caused sales to "decrease[ ] dramatically in the second quarter" (Ex. J-29 at 7). Thus, the only apparent ways that "processing of additional allowances" could "reduc[e] the net sales number" would be if the actual sales allowance claims approved in 2004 were higher than the corresponding estimated sales adjustments recorded for them at the time of sale or if those approved claims were based on prior-year sales. This suggests either that the 2004 estimates were too low or that the sales adjustments for 2004 were being depleted by sales allowance claims based on sales from a prior year. Either way, if Laccetti "took comfort" in this, he lacked a basis in the third procedure for doing so.

Fourth, the audit team again looked at cash collections and net sales. This time, the team calculated a two-year, 2003-2004 average of cash collections divided by gross sales, rendered that figure as a percentage (41.66%) and multiplied it by 2004 gross sales ($580 million), yielding a dollar expectation for 2004 net sales ($241.7 million) that the team then compared to actual 2004 net sales ($248 million). Ex. L-22 at 1640 (work paper containing the calculations, without elaboration). Laccetti testified that the $6.3 million difference between the actual and expected net sales was "in the reasonable range," "from an estimation perspective," because he knew that Taro USA "processed more credits during 2004 than they did in 2003," and thus the procedure "gave us comfort that they were doing a good job estimating allowances." R.D. 139a at 931.

No explanation is given for why an average of 2003 and 2004 results is the basis for a reasonable expectation for 2004 results here, whereas 2003 results are used in other analytical procedures and are rejected as a basis for direct comparison or averaging with 2004 in the DSR procedure. The "Average cash collections %" and $6.3 million difference therefore appear to be arbitrary choices. Nor does Laccetti provide any reference point or analysis in declaring them to be "in the reasonable range."

This fourth procedure does no better job than the third of explaining the large decrease in net sales from 2003 to 2004. Laccetti's reason for deeming the results reasonable here is the same unsupported view just discussed that lower than expected net sales can be explained by Taro USA "process[ing] more credits during 2004 than they did in 2003." If by this he means that net sales could drop in 2004 because Taro USA processed more of the total sales allowance claims it would receive that year based on that year's sales than it had done in 2003, then that, too, is inconsistent with the record. Regardless of whether Taro USA processed a sales allowance claim in the same year as the sale giving rise to it, the company made a sales adjustment for that claim at the time of sale that would stand in for that claim until it was received and processed. Net sales would be unaffected by when the claim was actually processed, so long as the estimate matched the claim. If it did not, then that could indicate a problem with the sales adjustments and related reserves. Thus, the fourth procedure did not show that Taro USA was "doing a good job estimating allowances."

The same is true of two additional analytical procedures Laccetti cited before the hearing officer as tests of Taro USA's 2004 accounts receivable allowances as a whole: (1) a calculation of year-end net accounts receivable as a percentage of net sales for 2001 through 2004 (41%, 50%, 40%, 50%); and (2) a "lag analysis," which, "assuming average of 110 days to collect receivables," showed "Prior net A/R still open" at the end of each successive quarter of 2004 ($41,220,640, $67,745,445, $38,939,962, $48,961,234). R.D. 180 at 75, citing Ex. L-22 at 8, 12.

No work paper, testimony, or argument in this case explains how, if at all, the first of these two additional procedures supported the reasonableness of the sales allowance estimates. The broad comparisons do not isolate the sales allowances or movements within them or identify circumstances that might explain the percentages. They are related to the original DSR calculations, which raised, not allayed, concerns.

As to the lag analysis, the record indicates it was not designed to be predictive of the year-end reserves balance but served a more general purpose. Laccetti testified that he was concerned that falling cash collections could indicate a problem with the reserves. R.D. 135 at 409-10, 466-68; R.D. 139a at 923-24. He further testified that he believed that the purpose of the lag analysis was "to show that there was a slowdown in cash payments" to Taro USA, consistent with a note at the top of the work paper stating, "Per management slow down in cash collections is due to delays in payments made by three major wholesalers that account for over 60% of Taro USA's business." R.D. 135 at 387-88. Even if, as the senior manager testified in the investigation, the purpose was "just to get a sense of what could be the potential net AR that was still out there" at year-end 2004 from prior periods (Ex. D-303 at 116), the analysis was very imprecise. As noted, Taro USA did not provide any analysis matching cash collections or accounts receivable allowances to sales. The broad assumption in the lag analysis of "average of 110 days to collect receivables" was based on 2003 DSR, which Laccetti rejected as an expectation for 2004, not the much higher 2004 DSR figures of 170.84 days (unadjusted) or 150 days (adjusted), or the even higher cash-collection based calculations of 191.48 days for 2004 or 244.34 days for September 2004 to January 2005. To the extent the lag analysis showed a slowdown in cash collections in 2004, it did not indicate the cause or examine any prior period. As to the cause, it appears from the work paper that Laccetti simply accepted management's representation.

In conclusion, for the reasons discussed, the analytical procedures that Laccetti has cited in addition to the DSR analysis provided little or no substantive evidence of the reasonableness of Taro USA's 2004 year-end total reserves balance.[18/]

3. Confirmations testing and alternative procedures

The Accounts Receivable Memorandum discusses the confirmations work, identifying it, after discussing the DSR analysis, as one of five items that the audit team evaluated to "gain some more comfort with the accounts receivable balance" and as providing "additional comfort that the client is able to collect on the outstanding receivables." Ex. L-22 at 6. According to the work papers, "[t]o determine that receivables in A/R Aging at 10/31/04 exist and are correctly valued," the audit team randomly selected 130 open invoices, totaling $73 million, from the aging report, each representing "the actual invoice that was submitted to the customer," and sent confirmation requests to the customer. Of these invoices, 25%, totaling about $19 million, were "undisputedly confirmed," and "we traced almost 75% of the remaining receivables," "for which confirmations were not received (or $54 million)," "to subsequent collections"; the result was that "[o]nly $2,000 of the selection made could not be verified," representing the sum of the only amounts not confirmed by customers

[18/] We do not decide whether, as the Division contends and Laccetti hotly contests (R.D. 205 at 6-7, 24; R.D. 210 at 9-10; R.D. 215 at 7), AU § 329 affirmatively required him to calculate and/or compare certain ratios, which were planned for the 2004 Taro USA audit or appear in the work papers for that audit, of sales adjustments to gross sales, on the one hand, and year-end accounts receivable reserves to gross accounts receivable, on the other (or variants of those ratios specific to chargebacks).

who had responded to the confirmation requests. *Id.* at 6, 1625-36; Ex. L-110 at 42; Ex. L-174; *see* Ex. D-63 at 8 (Revenue Recognition Memorandum). Based on the confirmations received and the alternative procedures performed, the team concluded that the year-end 2004 gross accounts receivable balance ("Trade A/R balance") was "without material misstatement." Ex. L-22 at 1628.

Nothing in the work papers or testimony specifies how this testing of gross accounts receivable would have addressed the accounts receivable reserves. Laccetti does not claim this procedure helped to verify or explain a slowdown in cash collections in 2004 asserted by Taro USA and of concern to him during the audit. He testified that the procedure was meant "to determine that the invoices that [the company] issued were real," that is, "to confirm that the invoice amounts that [it] had recorded [on the aging report] were in agreement with the client's records." R.D. 137 at 850; R.D. 139a at 918. The selections were limited to open invoices as of October 31, 2004 and did not include any open credits or open deductions, which in Taro USA's accounting system encompassed approved, pending, or unapproved sales allowance claims. Ex. L-22 at 1625; L-174; R.D. 135 at 459-60. Less than the full amount of an invoice might be paid due to a sales allowance claimed by the customer arising from that or some other transaction, and this would have implications for the relevant reserve. But there is no evidence that this procedure involved confirming with the customer (*see* R.D. 144 at 2631-32) (Laccetti's expert)) or otherwise testing the validity of such a claim, much less testing whether it was properly covered by or discharged from the appropriate reserve.

Furthermore, even if this procedure had involved evaluation of the validity of sales allowances claims or checking them against accounts receivable reserves, there were serious limitations to its usefulness in assessing the adequacy of the reserves. If some of the amount billed on a selected invoice were offset by a chargebacks claim, Laccetti would not have been able to obtain comfort about the estimation of the reserve by tracing that chargeback to a particular sales deduction corresponding to it in the reserve, given his acquiescence in Taro USA's view that it was too difficult to identify and keep track of chargebacks by the transactions that had given rise to them, to provide an analysis of the lag between sales and sales allowance claims arising from them, and to make a detailed calculation or specific estimate for chargebacks. If all the testing did was essentially check consistency of Taro USA's accounts receivable collections with its bad debts reserve, then the testing would not have been directed at whether Taro USA reasonably estimated the reserves for the specific sales allowances. Comfort about the collectability of the full amount currently owed on invoices is not the same as comfort about the amounts that ultimately will be realized on the sales, once all sales allowances claims arising from those transactions that will validly be made have been satisfied. For these reasons, there is no evidence that the confirmations testing and alternative procedures would have significantly supported the part of the year-end 2004 accounts receivable reserves balance not already individually tested.

4. Audit analysis of certain items on the year-end aging report

On February 8, 2005, Laccetti had noted he was “now asking for account level detailed analysis from the Company to support [Taro USA’s] position” that “the accounts receivable are fairly stated as currently presented.” Ex. D-87 at 1. The audit team selected certain items from Taro USA’s year-end accounts receivable aging report and asked the company to “provide us with some analysis to support that you are adequately reserved.” Ex. D-82 at 1; Ex. D-84 at 1; Ex. D-85; Ex. D-86 at 1. It was this audit work to which the Summary Review Memorandum referred when stating that, due to the deficiency in Taro USA’s estimation process, “we expanded our procedures to perform detailed substantive tests of individual accounts receivable to gain comfort that the amounts were properly recorded at net realizable value.” Ex. D-125 at 4; R.D. 135 at 414-17; R.D. 137 at 535-36. Laccetti testified that, in response to his concerns about the 2004 cash collections, management had represented that Taro USA’s major wholesalers “were not paying on terms, they were kind of stringing them out, and Taro had little leverage to put pressure on them.” R.D. 139a at 923-25. He further testified that the “account level detailed analysis” consisted of “validat[ing] a little bit more” about “some of these older aged accounts related to the wholesalers,” through “obtaining account level information,” and “represent[ed] additional procedures that we performed to understand…the detail.” R.D. 137 at 491-92; R.D. 139a at 927, 952-53.

On a work paper entitled “AR Aging 12-31-04,” consisting of spread sheets with 36,875 line items of Taro USA’s year-end receivables, the audit team placed one of six tick marks next to nine of those items, totaling $12,158,275. The selected items, an open invoice and eight open debits, were all listed on the aging report as unpaid for longer than 90 days. In five cases, the customer was one of Taro USA’s three largest wholesalers, and, in the other four, one major drugstore chain. The end of the work paper provided descriptions for five of the six tick marks, reporting information from Taro USA; the sixth, placed beside the largest of the nine items, a $3.2 million open debit for one of the three wholesalers, was left blank. Ex. L-23 at 1214-1215, 2129. As to the wholesaler items for which the tick marks provided information, the descriptions stated that payment of the $802,429 open invoice was expected based on the customer’s payment history; that a $792,449 billback inadvertently taken twice was being actively pursued by Taro USA; that a $594,810 rebate claim for which the customer was not eligible had been denied and Taro USA was confident based on past practice it would be withdrawn; and that a $2,778,876 rebate deduction had been “fully reserved for and is part of the existing reserve against A/R.” The tick mark describing the other four items stated that they were “offset by credit amounts on the aging report,” except for $131,000 that would be offset against the chain’s next payment. Ex. L-23 at 2129; *see* Ex. R-12 at 2 (Taro USA management representation letter to Ernst & Young, dated February 18, 2005, stating, “Receivables classified as current includes an amount of approximately $792,000 relating to rebates inadvertently taken by a Wholesaler, which is fully collectible and we should expect to collect within the next year.”). A concluding note under the tick marks stated Taro USA was “dependent on three very large wholesalers," who "have historically been slow in paying" and have put the company "at a disadvantage when it comes to collecting payment timely," but that management "is confident that the above items identified are fully collectible." Ex. L-23 at 2129.

Although this procedure did involve considering the validity of particular sales allowance claims and checking a sales allowance claim against a reserve, there is no evidence it provided any significant support for the part of the year-end 2004 reserves balance not already subjected to detailed individual testing. Laccetti's description of the procedure in terms of gathering modest incremental information, the lack of clearly expressed criteria and formality to the selection, and the relatively small number of items chosen all indicate that the scope and objectives of the procedure were very limited. Laccetti does not claim that this was a statistical or nonstatistical sample that would have allowed him to extrapolate the results of the direct testing to the larger population (*see* AU § 350). Nor do the work papers or testimony describe any risk assessment on which the choices might have been based. The audit team selected a small number of individually large, older receivables, some consisting of certain types of sales allowance claims. But there is no evidence that the selections reflected the total amount of each type of sales allowance claim in that age category on the aging report, much less represented the receivables on the overall aging report, taking into account, for example, whether certain types of allowances might be claimed in relatively small numbers of larger amounts and others in relatively large numbers of smaller amounts.

The only sales allowance claims referred to in the tick marks are a billback, two rebates, and unevaluated "credit amounts" of unidentified type. This procedure was subject to the same limitations identified in the concluding paragraph of our discussion of the confirmations work. Focusing on the aging of some open accounts receivable is not systematically analyzing the credit claims received, those processed, and those rejected by Taro USA in 2004 with a view to assessing its estimation of its year-end reserves. And apart from the billback entry, stating that Taro USA has shared "email correspondence with [Ernst & Young] relating to [the company's] claim" that it was actively pursuing payment, nothing in the descriptions indicated they were supported by more than untested management assertions. Indeed, one tick mark, for the $594,810 rebate, was stated in the first person from Taro USA's point of view: "[Due to wholesaler's ineligibility for claimed rebate] we have denied this claim and requested payback. We are confident in having this deduction removed by [the customer] as they have been cooperative in the past with items like this." Ex. L-23 at 2129.[19/]

[19/] Before the hearing officer, Laccetti claimed to have relied on two additional procedures as tests of accounts receivable allowances as a whole: (1) "randomly select[ing] three months and test[ing] the reconciliation of accounts receivable to the general ledger in order to gain comfort that the underlying accounts receivable ledger reconciles to the general ledger"; and (2) obtaining a written representation from management that "adequate provision had been made for losses, costs, and expenses

C. Summary of Findings of Violation

Based on the foregoing analysis, the Board finds that the Division proved by a preponderance of the evidence that Laccetti, acting as the auditor with final responsibility for the 2004 Taro USA audit, violated PCAOB Rules 3100 and 3200T. He did so by failing to comply with numerous PCAOB auditing standards in his work on Taro USA's 2004 sales allowance reserves as a whole.

The Division proved that Laccetti had an understanding of Taro USA's process for estimating accounts receivable allowances as a whole and chargebacks that heightened the rigor required of the overall audit work on the total balance. The Division proved that the combination of procedures Laccetti used to assess the accounts receivable allowances as a whole did not, in many respects, comply with PCAOB auditing standards and was insufficient to provide reasonable assurance that Taro USA's 2004 financial reporting package was free of material misstatement. In particular, the audit work on Taro USA's individual 2004 sales allowance reserves other than chargebacks did not contribute significantly to evaluation of the rest of Taro USA's total 2004 reserves balance; the comparison of the year-end 2003 and 2004 chargebacks reserve balances and the days sales in accounts receivable analysis undermined, rather than supported, the reasonableness of the total balance; the other analytical procedures were too general to provide the high level of assurance sought from them; and the review and testing of the 2004 interim and year-end aging reports was too limited to yield the necessary additional support for the total reserves balance.

The Division further proved that, in assessing the total balance, Laccetti repeatedly relied on untested management representations, such as in the DSR analysis and in the procedures on Taro USA's year-end 2004 aging report, and that he uncritically accepted an insupportable management representation about the steep drop in the year-end chargebacks reserve from 2003 to 2004. The representation about the change in the chargebacks reserve over that period did not explain the magnitude of the change or a valid reason for the change, was based on a calculation Laccetti claims to have believed was "crude and unsuitable for use in connection with the issues of accounts receivable estimations and revenue recognition," and was contrary to the

that may be incurred subsequent to 12/31/04 in respect to sales made prior to that date." R.D. 180 at 49 (citing Ex. L-110 at 32-33), 76 (citing Ex. R-12 at 2); R.D. 180a at 84. But neither of these basic procedures—the first of which concerned the general reliability of data in the accounts receivable ledger, not specifically the reasonableness of the level of accounts receivable reserves, and the second of which is "not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion," AU § 333.02—could compensate for the insufficiency of the combination of other procedures used by Laccetti to test accounts receivable allowances as a whole.

contemporaneous increases in gross sales, processed chargebacks, gross receivables, other major sales allowance reserves, and total sales allowance reserves.

Additionally, the Division proved that Laccetti did not do enough to address numerous factors that called into question Taro USA's ability to reasonably estimate accounts receivable allowances and that indicated heightened risk surrounding the adequacy of those allowances that demanded that he apply greater audit scrutiny. Such information included management's asserted lack of inventory data from wholesalers, lack of any detailed calculation or explanation for its estimation of accounts receivable allowances as a whole or chargebacks, lack of ability to match chargebacks to the sales that gave rise to them, and lack of any determination of the lag time between the sales and the claims, as well as the substantial, unexplained increase in the number of days Taro USA's sales were going uncollected in 2004. Despite claiming to have expanded the audit procedures and audited around a process deficiency, Laccetti did not employ any effective additional or alternative procedures.

Accordingly, we find that Laccetti, in his audit work on Taro USA's year-end 2004 accounts receivable allowances as a whole, (1) violated AU §§ 150 and 230 by failing to exercise due professional care, which requires observing the standards of field work, "diligently perform[ing]" the "gathering and objective evaluation of evidence," and exercising professional skepticism, "an attitude that includes a questioning mind and a critical assessment of the audit evidence," according to which the auditor "should not be satisfied with less than persuasive evidence because of a belief that management is honest"; (2) violated AU §§ 150 and 326 by failing to be "thorough" in his "search for evidential matter" and "unbiased in its evaluation," to "consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions" in the financial reporting package, and to obtain sufficient competent evidential matter to provide a reasonable basis for forming an audit opinion; and (3) violated AU § 342 by failing to evaluate the reasonableness of a significant accounting estimate. We further find that, by not adequately evaluating the contrary audit evidence, Laccetti failed in his assessment of whether Taro USA was able to reasonably estimate accounts receivable allowances as a whole and therefore did not perform audit procedures sufficient to evaluate Taro USA's compliance with GAAP, in violation of AU §§ 150, 230, and 326.

In addition, we find that Laccetti violated AU § 333 by accepting management's explanation for the dramatic decrease in the chargebacks reserve, despite audit evidence contradicting that representation, without meaningfully investigating the circumstances. We also find that, in conducting the DSR analysis, Laccetti failed to comply with numerous provisions of AU § 329: § 329.21, which provides that the auditor "should evaluate significant unexpected differences," and, lacking an explanation, "should obtain sufficient appropriate audit evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a likely misstatement"; § 329.17, providing that the expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements would be identified; § 329.20, providing that the amount of the difference from expectation that can be accepted without further investigation should be consistent with the level of assurance desired; § 329.18, stating, "More effective identification of factors that significantly affect the relationship is generally needed as the desired level of assurance from analytical procedures increases."; § 329.14, stating, "As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation."; and § 329.13, stating, "It is important for the auditor to understand the reasons that make relationships plausible…."

The initial decision found that the Division proved by a preponderance of the evidence that Laccetti violated PCAOB Rules 3100 and 3200T and AU § 316.64 due to the lack of a retrospective review of Taro USA's 2004 accounts receivable allowances. I.D. 75-77. Only sanctions issues are raised on review with respect to that violation.

Finally, we do not find a violation of AU § 560 or of AU § 561.[20/]

[20/] The Division argues that Laccetti violated AU § 560 because, during his work on the 2004 audit, he obtained information about sales allowance claims processed by Taro USA after the balance sheet date but did not evaluate them to the extent planned or, in the case of chargebacks, at all, to assess the adequacy of the corresponding year-end reserves. R.D. 205 at 6, 18-19; R.D. 215 at 8; R.D. 168 at 128-30; R.D. 182 at 29-30, 40-43. Laccetti disputes the Division's interpretation of the work papers and the applicability of AU § 560. R.D. 210 at 11-12; R.D. 180a at 230-37. Under the plain language of the standard, processed sales allowance claims could be a type of subsequent "event[ ] or transaction[ ]" that could "provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements" and therefore could require "evaluation by the independent auditor." *See* AU §§ 560.02, .03; *see also* AU § 560.04 (identifying events of this type "calls for the exercise of judgment and knowledge of the facts and circumstances"). But even assuming that such an evaluation were required here, the Division did not prove that Laccetti failed adequately to evaluate subsequent processed credit claims corresponding to those accounts receivable reserves that were assessed individually in the audit, and we do not reach the issue of whether PCAOB standards required that Taro USA's chargebacks estimate be assessed individually, rather than through accounts receivable reserves as a whole.

The Division argues that Laccetti violated AU § 561 (and relatedly AU § 333) because he did not "consider the effects on his audit report" of statements in a mid-2005 letter to SEC staff by Taro USA's parent company that "we monitor inventory in the channels based" on certain factors, allowing it to "reasonably estimate the level of inventory in the distribution channels and properly recognize revenue" (Ex. D-294 at 6). R.D. 205 at 19. According to the Division *(id*. at 22-23), these statements contradicted statements made by the parent company in a December 17, 2004 letter to SEC staff

VI.

A. The Division's Challenge to the Hearing Officer's Exclusion of Certain Post-Audit Evidence

The Division argues in its appeal briefs that the hearing officer erred by excluding 11 proposed hearing exhibits, including excerpts from a transcript of investigative testimony, "that, if admitted, should have affected the liability and sanctions determinations." R.D. 205 at 26. Laccetti disagrees. R.D. 210 at 15-17. We discuss the issue of the admissibility of the 11 proposed exhibits because it has been properly raised on appeal and to provide guidance to PCAOB hearing officers, but the issue does not affect our review of this case.

The excluded exhibits were created after the 2004 audits of Taro USA and its parent company. These exhibits fall into three general categories: (1) excerpts of the February 27, 2008 investigative testimony of an Ernst & Young national office partner who coordinated a review of the 2004 Taro USA audit, in response to questions from SEC staff to the parent company about its Form 20-F, and two documents related to that partner's review (proposed Exs. D-306, D-171, D-213); (2) documents prepared in 2006 that, according to the Division, show that Laccetti contended, in urging additional audit procedures for the 2005 Taro USA audit, that there were inconsistencies, pertinent to Taro USA's accounts receivable allowances, between the parent company's responses to the November 24, 2004 and March 24, 2005 SEC staff comment letters, supporting the Division's argument that he should have investigated the discrepancies earlier (proposed Exs. D-174, D-177, D-185, L-134); and (3) a December 29, 2005 SEC staff comment letter to the parent company and versions of an outline that Laccetti helped prepare in response that, the Division argues, contain inaccurate statements about procedures performed during the 2004 Taro USA audit (proposed Exs. D-163, D-161, D-170, D-183).

PCAOB Rule 5441 states that the hearing officer "may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious." As

that "[w]e have no way of knowing or reasonably estimating (i) the actual levels of inventory in our distribution channels or (ii) the then-current inventory policies, or desired inventory levels, of our distributors" (Ex. D-44 at 3). Laccetti argues that the statements in the second letter clarified, rather than contradicted, the statements in the first and suggests that "the time frame requirements of AU § 561" may not apply to the period of the second letter, which postdated the Taro USA audit report for 2004 and preceded the issuance of the principal auditor's audit report and the parent company's 2004 consolidated financial statements. R.D. 210 at 12-14 & n.10. We have thoroughly discussed Laccetti's understanding of Taro USA's estimation of sales allowances based on detailed other evidence, and need not, and do not, rely on the alleged contradiction in the letters or resolve these charges that are grounded entirely in such a contradiction.

the Board noted in adopting the rule, “Rule 5441 is not intended to limit a hearing officer’s authority to exclude or allow evidence based on reasonable principles of admissibility, but is intended to allow a hearing officer reasonable flexibility,” affording the hearing officer “discretion to resolve evidentiary issues.” PCAOB Release No. 2003-015 at A2-113 (Sept. 29, 2003). Rule 5424 provides that, in connection with any hearing ordered by the Board, “a party may request the issuance of an accounting board demand of a registered public accounting firm or an associated person of such a firm, or an accounting board request of any other person” and “upon application of any party or on its own initiative, the Board may seek issuance by the Commission of a subpoena to any person…requiring the person to provide any testimony or produce any documents that the Board considers relevant or material to a Board proceeding.” And Rule 5426 identifies five circumstances in which a motion to introduce a prior sworn statement of a nonparty witness in lieu of live testimony “may be granted” by the hearing officer, including that “the party offering the prior sworn statement has been unable to procure the attendance of the witness by accounting board demand” (here, the hearing officer denied the Division’s request for issuance of such a demand to the Ernst & Young national office partner because he had retired, R.D. 157 at 7) and that, “in the discretion of” the hearing officer “it would be desirable, in the interests of justice, to allow the prior sworn statement to be used”; “In making this determination, due regard shall be given to the presumption that witnesses will testify orally in an open hearing.”

Preliminarily, we note that the hearing officer’s explanations for excluding from evidence materials in the first and second categories would appear to fall within the reasonable flexibility afforded by Rule 5441 for resolving evidentiary issues. In ruling the national office partner’s testimony inadmissible, for example, the hearing officer observed that it “sets forth his impressions and conclusions formed in 2006, long after the 2004 audit was concluded” and pointed out the difficulty of “assess[ing] what, if any weight, should be ascribed to the testimony in evaluating whether Laccetti complied with PCAOB auditing standards in conducting the 2004 Taro [USA] audit,” given that the testimony “consists of broadly stated and somewhat ambiguous impressions and conclusions formulated in 2006 coupled with the fact that [the partner] did not testify at the hearing.” R.D. 157 at 4, 8-9. In excluding the second set of exhibits—those offered solely for alleged inconsistencies between the parent company’s responses to SEC staff letters (*see* R.D. 205 at 23 n.13, 28)—the hearing officer stated that any probative value they might have was minimal compared to “the documents [in the record] that were created during the course of the 2004 audit,” yet would require inquiry into “collateral events in 2006,” in that the exhibits, from 2006, mostly referred to inconsistencies between letters to SEC staff and company representations to Ernst & Young during the 2004 audit, without specifying the inconsistencies or the representations, and contained a clear indication that the perception of inconsistencies referred to in 2006 was shaped by information acquired after the 2004 audit (*see* Ex. D-185 at 2). R.D. 157 at 13-14.

On the other hand, the hearing officer’s stated grounds for excluding the third category of exhibits appear to be inadequate or incorrect. These exhibits include statements prepared for the Ernst & Young national office partner and Taro USA's parent company's principal auditor, in response to a December 29, 2005 SEC staff letter to the parent company asking it to "have your auditors explain to us how they became satisfied that the balance of accrued returns and price adjustments at December 31, 2003 and 2004 were fairly stated" (Ex. D-163 at 3). The exhibits purport to list procedures used in the 2004 Taro USA audit by the very auditors who performed or supervised them—Laccetti and the senior manager—that the Division argues were not done. After an extended colloquy among counsel, upon objection at the hearing to the Division's use of one of the exhibits as foundation for further questioning of Laccetti about the exhibits, the hearing officer stated, "I don't see any basis for excluding Mr. Laccetti's statements here. I think there may be circumstances that affect the weight that can be given to them, but I haven't heard anything that suggests anything be excluded." R.D. 137 at 565-76. The Division's questioning of Laccetti on Ex. D-163 proceeded, and then moved on to Ex. D-161 and similar exhibits (not briefed here).

But when the Division asked Laccetti if his statement in one of the exhibits was inaccurate, the hearing officer interrupted and would not allow further questioning in that line, stating: "It sounds like you're trying … to prove that [Laccetti] was not candid in comments he was offering back, but that's not a part of the charges in this case."; "No, I'm not going to hear that [that the exhibit is relevant to sanctions]"; and "No, you're not going there. I said you could go ahead on the theory that you were offering statements that he made as admissions relating to what, in fact, had been done[,] [not]…going off on a cross-examination on communications that are sort of extrinsic to this case." R.D. 137 at 586-88. When the Division made an offer of proof on the other two exhibits (Exs. D-170 and D-183), the hearing officer reiterated his view that the exhibits "don't relate to the charges in the OIP. Then you would be going, well, let's prove something else in an audit in 2007. … No. It's got to relate to the circumstances in the OIP." *Id.* at 608-09.

When, after the hearing, the Division moved for admission of the third group of exhibits on the additional ground that they were relevant to Laccetti's "understanding of what should have been done during that audit and [knowledge] he had made a mistake in completing the audit," the hearing officer denied the motion. The order reasoned that:

> The issues in this case relate to whether Laccetti violated PCAOB auditing standards in certain respects during the 2004 Taro [USA] audit. Even if the Division's contention that the outlines included "false and/or misleading statements" regarding the 2004 audit were accepted, those statements were offered in 2006, long after the 2004 audit was concluded. Laccetti's state of mind in 2006 is irrelevant to any reasoned judgment of his state of mind during the 2004 audit. Moreover, the Division's characterizations of the statements in the various outline drafts are unquestionably subject to dispute. To properly evaluate the statements it would be necessary to reconvene the hearing in order to conduct an inquiry into the context in which the statements were made in 2006. Such

> an inquiry into events remote in time and circumstance in order to clarify the meaning of statements that would be entitled to no significant weight in any event would be entirely unjustified.

R.D. 157 at 12. The order later reiterated that "to properly evaluate the statements in these documents, it would be necessary to reconvene the hearing in order to embark on a possibly extensive inquiry into completely collateral events in 2006." *Id*. at 14.

In light of the hearing officer's stated reasons for excluding the third group of exhibits, we discuss the issue to avoid any misunderstanding about use of post-audit evidence. It is well recognized that evidence showing that a person gave false or misleading accounts of his or her conduct to investigators or others can be probative of the occurrence of underlying misconduct.[21/] Moreover, evidence of misrepresentations made in response to questions about possible misconduct can also be, and often is, relevant to determining the appropriate sanction. The SEC commonly considers deceptive conduct committed after the charged violation as support for imposing its own sanctions.[22/] And the sanctions guidelines of at least one securities industry self-regulatory organization specifically direct its adjudicators to deem it an aggravating factor when a respondent attempts to conceal his or her misconduct or mislead regulators or his or her own firm.[23/] Notably, Laccetti himself contends it is relevant to

[21/] *See, e.g., SEC v. Sargent*, 229 F.3d 68, 78 (1st Cir. 2000); *SEC v. Musella*, 748 F. Supp. 1028, 1040 (S.D.N.Y. 1989) (finding that a defendant's "false exculpatory statement" to an SEC investigator who interviewed him after the violative insider trade "evidences consciousness of guilt and has independent probative value of scienter"), *aff'd*, 898 F.2d 138 (2d Cir. 1990); *SEC v. Lucent Techs., Inc.*, 363 F. Supp. 2d 708, 717 (D.N.J. 2005); *SEC v. Gold*, No. 05-CV-4713 JSMLO, 2006 WL 3462103 at *5 (E.D.N.Y. Aug. 18, 2006) (averral that auditors "attempted to conceal the deficiencies of their work" after the conclusion of the audit at issue by inserting false documents into audit work papers provided relevant factual basis for claim against them).

[22/] *See, e.g., Alfred Clay Ludlum, III*, SEC Rel. No. 3628, 2013 SEC LEXIS 2024 at *33-*34 (July 11, 2013) (basing sanction in part on evidence that respondent took steps to conceal fraud and made misrepresentations to investigators); *Gary N. Kornman*, SEC Rel. No. 34-59403, 2009 SEC LEXIS 367 at *27 (Feb. 13, 2009) (respondent's "deliberate attempt to deceive Commission investigators" "indicates a lack of honesty and integrity" and supports sanction), *petition denied*, 592 F.3d 173 (D.C. Cir. 2010).

[23/] *See* FINRA Sanction Guidelines at 6-7 (Principal Considerations 10 and 12); *John Edward Mullins*, SEC Rel. No. 34-66373, 2012 SEC LEXIS 464 at *76, n.85 (Feb. 10, 2012); *Gregory W. Gray, Jr.*, SEC Rel. No. 34-60361, 2009 SEC LEXIS 2554 at *36 (July 22, 2009) (affirming sanctions based in part on consideration as aggravating factor that Gray sought to conceal his misconduct from his firm).

sanctions that, in his (and, he claims, the hearing officer's) view, he "cooperated in the Division's investigation." R.D. 210 at 3 (basing claim on statement by the hearing officer (I.D. 9) simply that the Division's efforts to "impeach Laccetti's testimony in various respects" by showing that he made prior inconsistent statements during his investigative testimony "failed to undermine the overall credibility" of his hearing testimony).

A view that would reject the basic concepts we have been discussing, or that would fail to recognize that subsequent conduct need not be charged as a violation to be considered as evidence of a violation that is charged, would be a poor foundation for concluding that proffered evidence "would be entitled to no significant weight in any event." To be sure, "the Division's characterizations of the statements in the various outline drafts are unquestionably subject to dispute," and those characterizations might have proven to be entirely mistaken. But generic, conclusory statements about a need to "embark on a possibly extensive inquiry into completely collateral events" if proffered evidence were admitted would not be an adequate basis for excluding it.

Erroneous exclusion of post-audit evidence, including restatement evidence,[24/] could deprive the Board of information that it needs to properly analyze and evaluate, under the applicable auditing standards, the audit work at issue in a disciplinary proceeding. What the Board's rules require is fact-specific, case-by-case analysis of the admissibility of particular items of evidence in light of the specific details of that evidence, the particular circumstances of the case, and the particular foundation, reasoning, and authority offered for and against receiving the items into evidence. Rule

[24/] The Division's petition for review had taken issue with the hearing officer's exclusion of more than the 11 exhibits that the Division went on to brief on appeal, including the exclusion of one of the documents relating to the restatement (proposed Ex. D-210). We consider the Division to have abandoned that broader challenge, but note that a restatement corrects an error in previously issued financial statements that is due to facts that existed at the time the financial statements were prepared, in contrast to a change in accounting estimate, which results from new information. *See* Accounting Principles Board Opinion No. 20 ¶ 13, *Accounting Changes*; Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, ¶¶ 2.h & j, 3.d. A restatement thus reflects and addresses facts that existed at the time of the original financial statements. The mere fact that financial statements are restated does not prove a violation of PCAOB auditing standards, *see* AU § 230.10, but this would not be a basis for the blanket exclusion of restatement evidence, without regard to any factual particulars. Indeed, AU § 230.13 states that the subsequent discovery of a material misstatement does not "in and of itself" evidence failure to obtain reasonable assurance; inadequate planning, performance, or judgment; the absence of due professional care; or a failure to comply with PCAOB standards, on the part of the auditor. This indicates that, depending on the circumstances, the subsequent discovery of a material misstatement may be used as evidence of those matters.

5441 does not warrant exclusion of post-audit evidence on the automatic or routine assumption that its probative value is substantially outweighed by, for example, a danger of unfair prejudice, confusion, undue delay, waste of time, or needlessly presenting cumulative evidence. Whether or not the third category of exhibits should have been admitted, the reasons given by the hearing officer for excluding them appear to have been incorrect or inadequate.

We have decided, however, not to reopen at this stage the ultimate matter of the admissibility of these or any other of the 11 exhibits whose exclusion the Division challenges in its appeal briefing. Given the ample evidence in the record, we need not and do not consider any of this additional material in deciding this case.

B. Laccetti's Challenge to the Hearing Officer's Admission of the Division's Expert Witness's Report and Testimony

Laccetti argues that the initial decision should be reversed due to the denial of his motion to exclude the Division's expert witness' report and testimony or to conduct a separate "evidentiary hearing to explore [the expert's] unreliable testimony and bias," which ruling below violated Laccetti's "right to due process and a fair hearing." R.D. 204 at 12, 17, 19. Even if the hearing officer had erred, the error is harmless because we do not rely on the expert. *See generally PDK Labs., Inc. v. DEA*, 362 F.3d 786, 799 (D.C. Cir. 2004) ("If the agency's mistake did not affect the outcome, if it did not prejudice the petitioner, it would be senseless to vacate and remand for reconsideration."). We want to make clear, however, that the evidence was properly before us and we could have considered it, as Laccetti's claim of error is baseless.

Before the hearing, Laccetti moved to exclude the testimony and report of the Division's expert witness, on the grounds that the expert's report "contain[ed] inaccurate and misleading information" and was so "inherently biased" that it, and any related testimony given by the expert, could not be fairly relied upon. R.D. 72 at 1. Laccetti's claim was premised on the fact that the expert served as a consultant to the Division in this proceeding for several months before he was engaged to serve as an expert witness, but did not disclose this in his expert report. Laccetti asserted that the expert "purposely concealed his consulting role so that his inherent bias as a de facto member of the Division's investigative team was not disclosed." *Id.*at 2, 6. The hearing officer denied Laccetti's motion, noting, "Issues regarding an expert's bias, or inaccurate or misleading aspects of the expert's report, may be pursued through cross-examination at the hearing." R.D. 92 at 2. Laccetti now argues that this ruling was error "that infected the overall fairness of the hearing," and complains that, even though the hearing officer stated in the initial decision that he "gave only limited weight to the opinions offered by the expert witnesses," the decision nonetheless "agreed with numerous opinions offered by" the expert. R.D. at 18-19. Laccetti claims that "reversal" of the initial decision is the necessary cure for the hearing officer's "egregious error." *Id.* at 19.

The Board's review in this case is the cure of the error that Laccetti claims the hearing officer made. *See, e.g., Dearlove*, 2008 SEC LEXIS 223 at *34-35 & n.42 (*de novo* review of administrative law judge's initial decision), *aff'd*, 573 F.3d 801 (D.C. Cir. 2009). Specifically, we have conducted a *de novo* review of the record and base our findings and conclusions on the evidence in the record, without need for or use of the report or testimony of the Division's expert. There is an otherwise ample record in this case, and the Board, like the Commission, is fully capable of applying its own expertise to auditing matters and determining whether the evidence establishes conduct that failed to comply with PCAOB standards. *See, e.g., Dearlove v. SEC,* 573 F.3d 801, 805-806 (D.C. Cir. 2009). To the extent Laccetti argues that we can properly disregard the expert's testimony only by drawing no conclusions that are consistent with the expert's, we reject this logical fallacy. It is well within the Board's authority to make findings and draw conclusions based on the record evidence, regardless of whether such findings and conclusions agree with, or even flatly contradict, expert testimony.[25/]

Even more fundamentally, Laccetti's claim of error itself is unfounded. Service as both consultant and expert is far from exceptional or problematic; to the contrary, as the Division has pointed out, the practice of engaging a single person to serve first as litigation consultant and then as expert witness is unremarkable and commonplace.[26/] It is so common, in fact, that Laccetti's own expert and a co-respondent's expert each served as both consultant and witness.[27/] Courts do not, as a general rule, exclude expert testimony on the grounds that serving as a consultant *per se* renders the

[25/] *See, e.g., Wendy McNeeley, CPA*, SEC Rel. No. 34-68431, 2012 SEC LEXIS 3880 at *59-60 & n.54 (Dec. 13, 2012) (Commission "has its own expertise and is not bound by expert testimony regarding auditing standards") (citing *Haskins & Sells*, SEC Rel. No. 73, 1952 SEC LEXIS 1062 at *28 (Oct. 30, 1952)); *Dearlove*, 2008 SEC LEXIS 223 at *71 (expert testimony may be considered but is not binding); *Kirlin Securities, Inc.*, SEC Rel. No. 34-61135, 2009 SEC LEXIS 4168 at *56 n.74 (Dec. 10, 2009) ("neither we nor NASD is hindered by the lack of, or is bound by, expert testimony").

[26/] *See, e.g., Bro-Tech Corp. v. Thermax, Inc.*, No. 05-CV-2330, 2008 U.S. Dist. LEXIS 21233 at *10-11 (E.D. Pa. Mar. 17, 2008); *Schwab v. Philip Morris USA, Inc.,* No. 04-CV-1945, 2006 U.S. Dist. LEXIS 11047 at *10 (E.D.N.Y. Mar. 20, 2006).

[27/] *See* R.D. 88 (attaching (1) a Feb. 26, 2010 engagement letter stating that Laccetti's expert would be retained "as a consultant in connection with this representation," and that "[i]t is understood that at a later time it may be decided that you will prepare a report and/or testify in this matter as an expert witness"; and (2) a May 15, 2009 engagement letter explaining that the other respondent's expert's firm was being retained to "provide independent professional services" in the areas of "analysis of accounting and auditing issues" but that counsel had "not yet determined whether [it] will call any member of our firm as an expert witness in this matter").

testimony biased and unreliable. *See, e.g., MCC Mgmt. of Naples, Inc. v. Int'l Bancshares Corp.*, No. CIV-06-1345-M, 2010 U.S. Dist. LEXIS 10834 at *11-*12 (W.D. Okla. Feb. 8, 2010). It is well settled that bias is, instead, a question properly explored on cross-examination. *See, e.g., DiCarlo v. Keller Ladders, Inc.*, 211 F.3d 465, 468 (8th Cir. 2000) (rejecting argument that expert testimony should have been excluded on grounds of bias) (citing 4 WEINSTEIN'S FEDERAL EVIDENCE § 702.06[8] at 702–59 ("An expert witness's bias goes to the weight, not the admissibility of the testimony, and should be brought out on cross-examination.")). When courts do become concerned with differentiating the two roles, as illustrated by the cases Laccetti cites, it is often in the context of determining the extent to which the party offering the expert should be compelled to produce documents that were considered by the consultant/expert.[28/]

Here, the document on which Laccetti has focused is a draft copy of the OIP that was provided to the Division's expert's firm a month before this proceeding was instituted. The Division gave the document to Laccetti before the hearing. It was nearly identical to the final OIP, and was properly omitted from an expert report whose only relevance is to the question of whether the charges in the final OIP—the operative charging document—were substantiated. Exclusion of an expert's report or testimony is an extreme remedy.[29/] We can see no error in the hearing officer's decision to admit the expert's testimony and permit Laccetti to elicit evidence of bias on cross-examination.

Finally, the hearing officer did not err in declining to grant a pretrial evidentiary hearing in lieu of granting Laccetti's motion to exclude the expert's testimony. The threshold evidentiary hearing Laccetti requested (commonly called a *Daubert* hearing, after *Daubert v. Merrell Dow Pharms.*, 509 U.S. 579 (1993), and related cases) helps a federal court assess the validity of the methodology used in expert scientific or technical testimony based on several non-exclusive factors: (1) whether the theory or technique

[28/] *See, e.g., Colindres v. Quietflex Mfg.*, 228 F.R.D. 567, 572 (S.D. Tex. 2005); *United States Fid. & Guar. Co. v. Braspetro Oil Servs. Co.*, No. 97 Civ. 6124, 2002 U.S. Dist. LEXIS 111 at *28-29 (S.D.N.Y. Jan. 7, 2002) (ordering production where claim of privilege failed because defending party could not "clearly establish" documents were made available to persons only while they were acting as consultants).

[29/] *See, e.g., Derrickson v. Circuit City Stores, Inc.*, No. DKC 95-3296, 1999 U.S. Dist. LEXIS 21100 at *20 (D. Md. Mar. 19, 1999) ("Exclusion is a harsh sanction."); *Sullivan v. Glock, Inc.*, 175 F.R.D. 497, 504 (D. Md. 1995) (stating that exclusion of expert testimony in federal court "has traditionally been considered a severe sanction, appropriate only for willful and substantial abuse of the discovery process") (citing *McNerney v. Archer Daniels Midland Co.*, 164 F.R.D. 584, 586 (W.D.N.Y. 1995) ("[P]recluding testimony from an expert under [the Federal Rules of Evidence] is a drastic remedy and should only be applied in cases where the party's conduct represents flagrant bad faith and callous disregard of the federal rules.")).

in question can be and has been tested; (2) whether it has been subjected to peer review and publication; (3) its known or potential error rate; (4) the existence and maintenance of standards controlling its operation; and (5) whether it has attracted widespread acceptance within a relevant community. To the extent *Daubert* applies to administrative proceedings,[30/] a *Daubert* inquiry is not styled to address personal bias, and a *Daubert*-style hearing is not an appropriate vehicle for doing so.[31/] Laccetti, as well as his co-respondent, were properly given—and used—the opportunity to explore the expert's alleged biases through cross-examination during the hearing. For example, during that examination, Laccetti's counsel asked about, among other things, the extent of the work the expert performed for the Division in his role as consultant (answer: 7.75 hours over a six-month period), whether he had formed an opinion on the merits of the case before he agreed to serve as expert witness (answer: he had not), and whether all documents and information the expert reviewed in writing his report had already been made available to respondents (answer: they had). Laccetti has not articulated, and it is not apparent to us, how Laccetti's cross-examination of the Division's expert unfairly limited his ability to explore the expert's biases, or how a mini-proceeding dedicated to the subject of such bias would have, or could have, proven more useful or fair.

VII.

We reject the several affirmative defenses Laccetti presses on appeal.

[30/] *See, e.g., Bayliss v. Barnhart*, 427 F.3d 1211, 1218 n.4 (9th Cir. 2005) (explaining that neither *Daubert* nor the Federal Rules of Evidence govern the admissibility of evidence in administrative proceedings) (citing *Richardson v. Perales*, 402 U.S. 389, 400 (1971)); *Nat'l Taxpayers Union v. United States Soc. Sec. Admin.*, 302 Fed. Appx. 115, 121-22 (3d Cir. 2008) (unpublished) (declining "to endorse the application of *Daubert* to administrative proceedings" and to strike expert testimony); *but see Niam v. Ashcroft*, 354 F.3d 652, 660 (7th Cir. 2004) ("strictly speaking" neither Federal Rule of Evidence 702, nor *Daubert*, applies to administrative agencies but "the spirit of *Daubert*…does apply to administrative proceedings") (internal citations omitted).

[31/] *See, e.g., Daubert*, 509 U.S. at 595 ("Vigorous cross-examination, presentation of contrary evidence, and careful instruction on the burden of proof are the traditional and appropriate means of attacking shaky but admissible evidence.") (citing *Rock v. Arkansas,* 483 U.S. 44, 61 (1987)). *See also United States v. 14.38 Acres of Land Situated in Leflore County, Mississippi*, 80 F. 3d. 1074, 1078 (5th Cir. 1996) ("[T]he trial court's role as gatekeeper is not intended to serve as a replacement for the adversary system."); *Cage v. City of Chicago*, 979 F. Supp. 2d 787, 827 (N.D. Ill. 2013) ("[I]t is well-established that an expert's bias is not a proper basis to bar testimony under *Daubert*."); *United States v. McCluskey*, 954 F.Supp.2d 1224, 1240 (D.N.M. 2013).

A. Right To Counsel

Laccetti argues that this proceeding should be dismissed because he was denied his "right to counsel during the investigative stage" when the Division did not allow a particular partner from Ernst & Young to attend Laccetti's investigative testimony as an expert consultant. R.D. 204 at 12. This defense is moot because we need not and do not rely on his investigative testimony, but on other (and ample) record evidence. But, again, we want to make clear that use of the investigative testimony would in no way necessitate dismissal, because Laccetti has no sound basis for his claim of right.

Two months before Laccetti's scheduled appearance to give testimony in the investigation of the Taro USA audit, Ernst & Young's counsel asked that "when witnesses appear for testimony in this matter," Board staff "permit the witness to be accompanied by a technical expert consultant." R.D. 182 at 97; *see* R.D. 139a at 939-40 Counsel identified the consultant as a partner in Ernst & Young's general counsel's office, who could provide accounting and auditing expertise to counsel "at substantially less cost" than an outside technical consultant. R.D. 182 at 98. In denying that request by September 26, 2007 letter, the Division cited Board Rule 5102(c)(3)(iv). That rule limits those permitted to be present during investigative testimony to "the person being examined and his or her counsel, subject to Rule 5109(b)"; "any Board member or member of the staff of the Board"; "the reporter"; and "such other persons as the Board, or the staff of the Board designated in the order of formal investigation, determine are appropriate to permit to be present, provided, however, that in no event shall a person," other than the witness, "who has been or is reasonably likely to be examined in the investigation be present." The letter explained that excluding the expert was consistent with the release accompanying Board adoption of the rule. R.D. 180b at 2. In pertinent part, that release states that the Board "expect[s] the staff to be accommodating, but...also expect[s] the staff to be vigilant about not permitting a firm's internal personnel effectively to monitor an investigation by sitting in on testimony of all firm personnel." *Rules on Investigations and Adjudications*, PCAOB Rel. No. 2003-015 at A2–18-19. The concern is also reflected in Rule 5109(b)'s "provided, however" clause.

Laccetti gave his investigative testimony without an expert present. He now argues that the Division's denial of the request to permit his chosen expert to attend "violated his right to counsel in at least three ways." Even aside from the fact that we do not rely on his investigative testimony in deciding this case, which is the only prejudice Laccetti claims he would suffer, his arguments falter on his inability to establish the right he claims exists to attendance of a particular expert at his investigatory examination.

First, Laccetti notes that Rule 5109(b) confers a "Right to Counsel" during testimony before the Board, and argues that such right would be "meaningless if the examinee's counsel could not provide effective assistance to his client." In support of this argument, Laccetti cites *SEC v. Whitman*, 613 F. Supp. 48 (D.D.C. 1985). In *Whitman*, the court explained that "Congress expressly recognized that a witness subpoenaed to testify before an agency has a right to representation under the Administrative Procedure Act (APA)." *Id.* at 49. The court then concluded that the SEC's rules of practice, which excluded non-lawyers from attending its investigative proceedings and therefore worked to prevent counsel from being assisted by technical experts, improperly "impinge[d] upon counsel's ability to adequately represent his client who has been called upon to testify," running afoul of the APA's grant of his client's "absolute right to counsel during the proceedings." *Id.*

As the Board stated in the release accompanying its adoption of Rule 5109 and other rules, and as Laccetti acknowledges in his brief (R.D. 204 at 14 n.18), the APA does not apply to Board proceedings.[32/] But Laccetti urges us to look beyond the facial inapplicability of *Whitman* to take from it the premise that, where some "rule-based right" to counsel exists—here by virtue of Board Rule 5109(b)—then counsel must "have access to technical expertise" so as not to render that right "meaningless."

We first note that it has long been recognized that, in administrative contexts, the right to counsel exists only where the Constitution or some statute, rule, or regulation creates it. *E.g., Seuss v. Pugh*, 245 F. Supp. 661, 665 (D. W. Va. 1965). In *Whitman*, the court found the source of a right to counsel in the APA, which the court characterized as providing an "absolute right to counsel." 613 F. Supp. at 49. Here, Rule 5109(b) grants no such right; it allows circumscribed participation of a witness's counsel in an investigative examination:

> Any person compelled to testify pursuant to a subpoena issued pursuant to Rule 5111, or who appears pursuant to an accounting board demand or request, may be accompanied, represented and advised by counsel, subject to Rule 5102(c)(3), provided, however, that the counsel provide the Board's staff with a notice of appearance that states, or state on the record at the commencement of testimony, that the counsel represents the witness. [Emphasis added.]

[32/] *See Rules on Investigations and Adjudications*, PCAOB Rel. No. 2003-015 at A2–19 n.1 ("Whatever binding precedential value *Whitman* may have in the context of a Commission investigation, it has none in the context of a Board investigation. The *Whitman* decision rests on the requirements of the Administrative Procedure Act, which is not applicable to Board proceedings."); *see also* 5 U.S.C. § 551(1) (defining "agency" for purposes of the APA as "each authority of the Government of the United States, whether or not it is within or subject to review by another agency," with enumerated exceptions); 15 U.S.C. § 7211(b) ("The Board shall not be an agency or establishment of the United States Government...."); *Free Enterprise Fund v. PCAOB*, 561 U.S. 477, 485-86 (2010) (referring to "the [Sarbanes-Oxley Act] provisions specifying that Board members are not Government officials for statutory purposes").

The participation allowed by Rule 5109(b) is thus expressly made subject to Rule 5102(c)(3), which, as noted, limits attendees to the examinee, his or her counsel, Board members and staff, and such other persons as the Board, or Board staff designated in the order of formal investigation determine are appropriate to permit to be present.

Laccetti suggests that the Board cannot limit the attendance of experts at investigative examinations by contending that any right to counsel, once granted by statute or rule, "necessarily carries with it the right to have counsel assisted by retained experts." R.D. 204 at 14 n.18. But all the cases he cites for this proposition turn on the Sixth Amendment right to assistance of counsel "in all criminal prosecutions." These cases are therefore inapposite; it is well settled that there is no general constitutional or statutory right to effective assistance of counsel outside of the criminal setting.[33/]

Moreover, even if these cases applied to PCAOB proceedings, Laccetti could prevail on an ineffective assistance of counsel claim only if he could show that his defense was harmed for that reason, *i.e.*, that there is "a reasonable probability" that "the result of the proceeding would have been different." *Strickland v. Washington*, 466 U.S. 668, 694 (1984). Yet the Division did not exclude all experts, but only one, whose attendance the staff identified as inappropriate based on his employment by Ernst & Young. Any prejudice Laccetti claims to have suffered could fairly be attributed to his own decision not to seek out another expert in the two months before his scheduled examination. Nor does he claim to have been prevented from consulting with an expert in preparing for the examination, which lasted several days, or during breaks. And the only prejudice he claims is that "the Division's case rested in large measure on its use of Laccetti's investigative testimony." R.D. 210 at 23. Even if that assertion were true, it is irrelevant, because we have not relied on that testimony. Thus, even if Laccetti's flawed position were accepted, he has not shown that he would be entitled to any further relief than he is, in effect, receiving—"the typical remedy for a violation of the Sixth Amendment right to counsel," that "impermissibly obtained evidence is excluded."[34/]

[33/] *Hutcherson v. Smith,* 908 F.2d 243, 245 (7th Cir. 1990) ("It is a well-established principle of law that there is, in general, no constitutional or statutory right to effective assistance of counsel in civil cases."); *see also Hannah v. Larche,* 363 U.S. 420, 440 n.16 (1960) (Sixth Amendment "is specifically limited to 'criminal prosecutions'") (citing *United States v. Zucker,* 161 U.S. 475, 481 (1896)); *Williams v. Wynne,* 533 F.3d 360, 369 (5th Cir. 2008) ("the Sixth Amendment right to effective assistance of counsel is a criminal concept with no relevance to administrative or civil proceedings").

[34/] *See Bradley v. Health Midwest, Inc.*, 203 F. Supp. 1254, 1259 (D. Kan. 2002) (citing *United States v. Thurmond*, 1998 U.S. App. LEXIS 7132 at *1 (10th Cir. Apr. 8, 1998) (unpublished)); *see also Massiah v. United States*, 377 U.S. 201, 207 (1964).

Second, Laccetti argues that because “the Board is ‘part of the Government’ for constitutional purposes,” citing *Free Enterprise Fund v. PCAOB*, 561 U.S. 477, 486 (2010), it must not infringe the Fifth Amendment right to due process, a “critical component” of which is the right to counsel. He cites nothing, however, to overcome well-established authority that, even when due process requires access to counsel, that right attaches only during an adjudicative proceeding—during which here he was assisted by counsel and an expert witness—not during an investigation. *Hannah v. Larche*, 363 U.S. 420, 440-43 (1960); *In re Groban*, 352 U.S. 330, 333 (1957).[35/] His attempt to cast the same argument in terms of the requirement of Sarbanes-Oxley Act Section 105(a), 15 U.S.C. 7215(a), that the Board establish “fair procedures” for investigations fails for the same reasons that underlie those cases. Laccetti’s right to counsel was not infringed by exclusion of the particular expert from his examination.

Finally, Laccetti argues that even if *Whitman* and the Constitution are not a source of the right he claims to attendance of consultants during a Board investigatory examination, the SEC is compelled to recognize such a right in its own proceedings, with the result that the SEC would be unauthorized to approve sanctions imposed by the Board whenever a respondent’s expert consultant is excluded. The only support he cites for this argument is the statement in *Free Enterprise Fund*, 561 U.S. at 509, quoted without any context, that the SEC is “fully responsible for the Board’s actions.”

We can find no support in the law for the theory that restrictions under which the SEC may operate must pass through to organizations it oversees. Such a theory ignores Congress’s instruction that the PCAOB be established not as a government agency like the SEC but as a nonprofit corporation.[36/] The theory also ignores the existence of securities industry self-regulatory organizations (SROs). SROs are

[35/] *Accord, e.g., SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735, 742 (1984) (finding no offense to due process because “an administrative investigation adjudicates no legal rights") (citing *Hannah*); *Anonymous v. Baker*, 360 U.S. 287, 295-96 (1959) (applying *Groban* to grand-jury-like proceeding); *United States v. Steel*, 238 F. Supp. 575, 577 (S.D.N.Y. 1965) (“[W]hen a government agency is conducting an investigation, as here, in contrast to making an adjudication, ‘due process’ does not require granting to those being investigated ‘rights...normally associated only with adjudicatory proceedings.’”) (quoting *Hannah*, 363 U.S. at 442); *Kevin Hall, CPA*, SEC Rel. No. 34-61162, 2009 SEC LEXIS 4165 at *73 (Dec. 14, 2009) (distinguishing adjudicative from investigative processes in the application of due process principles) (quoting *Friedman v. Rogers*, 440 U.S. 1, 18 (1979) and citing *O'Brien* and *Hannah*).

[36/] *See* Sarbanes-Oxley Act Section 101(a) & (b), 15 U.S.C. 7211(a) & (b), *quoted in Free Enterprise Fund*, 561 U.S. at 484 (“Congress created the Board as a private ‘nonprofit corporation,’ and Board members and employees are not considered Government ‘officer[s]’ or ‘employee[s]’ for statutory purposes.”).

overseen by the SEC but reflect a congressional "prefer[ence] [for] self-regulation by a private body over direct involvement of a government agency," *First Jersey Secs., Inc. v. Bergen*, 605 F.2d 690, 698 (3d Cir. 1979), "as a means of providing an opportunity for participants in the securities market to review the conduct of their peers in an informal and flexible manner" and of "achieving expeditious and flexible enforcement of legal and ethical standards," *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363, 1370-71 (5th Cir. 1980). If Laccetti were correct, SROs would be required to adhere to all federal constitutional provisions simply due to SEC oversight, but that is not so. *E.g., Desiderio v. NASD*, 191 F.3d 198, 206 (2d Cir. 1999) (citing *Jackson v. Metropolitan Edison Co.,* 419 U.S. 345, 350 (1974)).

Moreover, the Board and SROs develop rules to carry out their missions, and provisions governing Commission review of Board or SRO rules do not require that they be the same as SEC rules, but rather that they meet certain standards. *See* 15 U.S.C. 7217(b); 15 U.S.C. 78s(b). The Board and SROs bring disciplinary proceedings, and while, in reviewing them, the Commission may consider whether the organizations applied their rules in a manner "consistent with [relevant statutory] purposes," the inquiry is not whether the rules were applied in the identical manner in which the SEC applies its rules. *See, e.g.,* 15 U.S.C. 7217(c)(2); 15 U.S.C. 78s(e)(1). Statutes require "fair procedures" or "a fair process" for such proceedings, not procedures or process identical to the SEC's. 15 U.S.C. 7215; 15 U.S.C. 78o-3(b)(8). In short, the Commission reviews proceedings according to the standards that apply to them, not to other proceedings. Laccetti's right to counsel defense is not only moot; it is baseless.

B. Separation of Powers

Laccetti argues that the Board should dismiss the charges against him because the statute that created the PCAOB "violates the [Constitution's] separation of powers, both on its face and as applied to these disciplinary proceedings." R.D. 204 at 19. The starting point of Laccetti's arguments is that the "Board's structure during the initiation, investigation, and prosecution of this matter" unconstitutionally "limit[ed] the SEC's authority to remove" Board members until the Supreme Court struck down, on separation of powers grounds, restrictions on removal of Board members other than for good cause (Sarbanes-Oxley Act, 15 U.S.C. §§ 7211(e)(6) & 7217(d)(3)) in *Free Enterprise Fund v. PCAOB*, 561 U.S. 477 (2010). According to Laccetti, dismissal of this proceeding is "compel[led]" by that case, as it establishes that the PCAOB generally exercised "unfettered, unaccountable enforcement authority" during the period the removal restrictions were in place, or, alternatively, dismissal is required for lack of a showing that "the SEC has ever exercised its authority over the Board with respect to this matter." R.D. 204 at 20-21. Neither argument has merit.

Regarding Laccetti's first argument, the Supreme Court's decision does not hold or even hint that the unconstitutionality of the statutory restrictions on the Commission's power to remove Board members invalidated "enforcement authority" exercised by the

PCAOB while those provisions were in place. As part of the same decision, the Court held that "the Board members have been validly appointed by the full Commission." 561 U.S. at 513. It also made clear that "restricting certain officers to a single level of insulation from the President affects the conditions under which those officers might someday be removed, and would have no effect, absent a congressional determination to the contrary, on the validity of any officer's continuance in office," dismissing as without "any substance" a claim by the dissent that the work of various officials likened to Board members "will 'be put on hold'" by the Court's decision. *Id.* at 508. Although the petitioners in that case "argued that the Board's 'freedom from Presidential oversight and control' rendered it 'and all power and authority exercised by it' in violation of the Constitution," the Court "reject[ed] such a broad holding." *Id.* Instead, the Court held that "the unconstitutional tenure provisions are severable from the remainder of the statute," that the statute "remains 'fully operative as a law' with these tenure provisions excised," and that petitioners were "not entitled to broad injunctive relief against the Board's continued operations" but rather "declaratory relief" of excision of the unconstitutional provisions. *Id.* at 508, 513. Laccetti himself acknowledges that "the decision's cure was prospective only." R.D. 210 at 25. Nothing in the Court's decision shows that vindication of the separation of powers requires invalidation of prior PCAOB actions in connection with a disciplinary proceeding.

Laccetti cites no authority in support of his position that we should interpret *Free Enterprise Fund* as invalidating any prior action taken by the PCAOB to investigate the basis for, institute, or prosecute a disciplinary proceeding. It is useful to note, however, that those few cases that were cited to the hearing officer when making similar (and unavailing) arguments below do not support Laccetti's position. All of those cases involved persons who were fundamentally ineligible to act, such as where statutes authorized persons controlled by Congress to perform executive branch functions.[37/] Laccetti has established no such fundamental ineligibility on the part of Board members.

[37/] In *Bowsher v. Synar*, 478 U.S. 714 (1986), the Court held that a 1985 statute giving the Comptroller General certain new duties related to deficit reduction measures violated separation of powers principles because Congress had the authority to remove the Comptroller General. The Court explained that "[t]he structure of the Constitution does not permit Congress to execute the laws; it follows that Congress cannot grant to an officer under its control what it does not possess" and concluded that "the Comptroller General, as an officer removable by Congress, may not exercise the powers conferred upon him" by the statute. *Id.* at 726, 736 n.10. In *Metropolitan Washington Airports Authority v. Citizens for Abatement of Aircraft Noise*, 501 U.S. 252 (1991), the Supreme Court held unconstitutional a board of review composed of members of Congress that had veto power over the decisions of regional airport authorities. The statute creating this review body, the court held, "provides a blueprint for extensive expansion of the legislative power beyond its constitutionally confined role," and was therefore impermissible. *Id.* at 276. In *FEC v. NRA Political Victory*

That is particularly significant to a separation of powers challenge, because, according to *Free Enterprise Fund*, what the separation of powers requires is that the President not be "impaired," "subvert[ed]," or "limit[ed]" by law in his "ability," "authority," or "power" to execute the laws and thus that the Commission have "authority over," and "wield a free hand to supervise," Board members. 561 U.S. at 496, 498, 504, 513-14. The Court stressed that the "only issue in this case is whether Congress may deprive the President of adequate control over the Board." *Id*. at 508. Eliminating an obstacle to the power to remove Board members does not require that the power actually have been exercised, or necessarily imply anything about the actions over which it might have been exercised, by a Board validly appointed, with authority severable from the removal provisions, and capable of continuing uninterrupted in office. This is clear from the Court's statement that, in practice, the President "can always choose to restrain himself in his dealings with subordinates," *id*. at 497, as can the Commission. And this is certainly true in the PCAOB context, where those choices would be made with the knowledge that "significant enforcement actions" by the Board "are, of course, subject to some latent Commission control," including authority to review Board decisions like this one. *Id.* at 486, 504. The two successive administrations that defended the constitutionality of the statute were content with what the Court viewed as "[b]road," even if not "plenary," power over the Board. *Id.* at 504.

Furthermore, the only oversight required by *Free Enterprise Fund*—Commission authority to remove Board members at will—has existed all the way back to the start of the hearing in this case. Any claims by Laccetti that he was subjected to "unfounded accusations, prosecutorial misconduct, and due process violations" (R.D. 204 at 21 n.30) were, to the extent he properly raised them, presented for consideration and resolution by the hearing officer and now us, as what the Supreme Court called "a constitutional agency accountable to the Executive," under a "'fully operative'" statute (561 U.S. at 508, 509, 513). We have given due consideration to the matters properly raised before us, and, for the reasons given, we have determined that specified charges against him were proven by a preponderance of the evidence and that this proceeding was conducted fairly and in accordance with applicable laws and rules. Although he notes that ultimate SEC review of a Board disciplinary sanction was held to be "insufficient to satisfy the separation of powers" (R.D. 204 at n.31)—as a substitute for striking down the removal restrictions—that does not mean that, in the wake of their

Fund, 6 F.3d 821 (D.C. Cir. 1993), the court found unconstitutional the composition of the Federal Election Commission, which had included agents of the legislative branch as *ex officio* members. It held that "the mere presence of agents of Congress on an entity with executive powers offends the Constitution." *Id.* at 827.

excision, the further conduct of the proceeding by the hearing officer, *de novo* review by us, and the opportunity for further review by the Commission is an insufficient remedy.[38/]

In, effect, Laccetti asks us to hold that the exclusive and essential remedy, if any PCAOB action were taken while the removal restrictions were in place to investigate the basis for, institute, or prosecute a pending disciplinary proceeding, is dismissal of the proceeding. This is so, in his view, regardless of whether any of those actions exceeded what the President or the Commission would have allowed, had they then possessed the power to remove Board members at will, and regardless of the Board members' eligibility to act, the nature of the separation of powers inquiry, the stance toward the PCAOB taken by successive Administrations, and the fact that the hearing and rest of the proceeding was conducted under the regime of *Free Enterprise Fund*, which had already ruled on the constitutionality of the statutory provisions. There is no warrant for Laccetti's position in anything cited to us or discovered in our research.

Laccetti's second argument would change the characterization of his constitutional challenge from "facial" to "as-applied" and reformulate the separation of powers inquiry as whether the Commission actually exercised or considered exercising "the executive power to start, stop, or alter" this "individual proceeding." R.D. 204 at 20-22 & nn.30, 31. Even if that were a proper standard for determining constitutionality, the Supreme Court has already declared the removal provisions unconstitutional. Laccetti's second argument offers nothing more than the first on the issue of remedy. Thus, it adds little, if anything, to the first argument, and fails largely for the same reasons.

As stated in a case Laccetti himself cites, he would bear the "burden to show" in an as-applied challenge "that the provisions of which [he] complains"—the removal restrictions—"are unduly severe," *i.e.*, "unduly constrain[ ] the President's ability to see that the laws are faithfully executed," in the "circumstances" here. *See Free Enterprise Fund v. PCAOB*, 537 F.3d 667, 670, 684 n.14 (D.C. Cir. 2008), *aff'd in part, rev'd in part, and remanded*, 561 U.S. 477 (2010). But the Supreme Court has already held that

[38/] Contrary to Laccetti's contention that dismissal of an enforcement proceeding is required if there is a separation of powers problem, courts have recognized there can be "'alternative way[s] of curing [a] constitutional violation.'" *FEC v. Legi-Tech*, 75 F.3d 704, 707-09 (D.C. Cir. 1996). Moreover, in *Doolin Securities Savings Bank, F.S.B. v. OTS*, the court indicated that, under commonly applied "harmless error" analysis, even if the charging document in an administrative proceeding were signed by an unauthorized official, this invalidity would not "cause the final order," which showed "detached and considered judgment in deciding the merits" by an authorized official, to be invalid. 139 F.3d 203, 212-213 (D.C. Cir. 1998). *Compare Landry v. FDIC*, 204 F.3d 1125, 1128, 1130-32 (D.C. Cir. 2000) (entertaining first-time claim that administrative law judge with purely recommendatory powers, to whom a statute required a matter be assigned, was invalidly appointed, despite agency's own determination of matter after *de novo* review).

the restrictions "contravene" and "violate the separation of powers" and thus are unconstitutional in all applications. 561 U.S. at 492, 508-10, 513-14. So for Laccetti to show that the Commission did not start, stop, or alter the present proceeding, or consider doing so, would be superfluous to establishing the unconstitutionality of the removal restrictions as applied to this case.

Further, Laccetti fails to provide any authority or analysis for why such a showing would require dismissal of this proceeding. Again, the Court held that once the restrictions were excised, the statute was "'fully operative as a law'" and the SEC was "fully responsible for the Board's actions, which are no less subject than the Commission's own functions to Presidential oversight," satisfying the separation of powers. *Id.* at 509. The four Board members participating in the review of this case are all eligible by law to act in that role, and three of those members did not sit on the Board when the proceeding was instituted. Thus, Laccetti's suggestion that this case could not continue after the Court's decision unless the President or the Commission then exercised, or considered exercising, the authority to "start, stop, or alter" the proceeding (R.D. 204 at 21-22 & nn.30, 31) would require dismissal simply because Laccetti disagrees with how the President or the SEC did or did not actually exercise their oversight authority over the Board. That is not for Laccetti to decide.

Moreover, Laccetti has not established that any failure by the Commission to act in the way in which he would have preferred was because the Commission was "prevented" from "exercising its authority over the PCAOB with respect to this matter" or that, as a result, he was subjected to a proceeding "fraught" with "unfounded accusations, prosecutorial misconduct, and due process violations" that otherwise "would not have occurred" or "would have been appropriately corrected," as he contends in his second argument (R.D. 204 at 20, 21 n.30). In defending the removal restrictions, the government expressed its view that the Sarbanes-Oxley Act did, in fact, provide the Commission with the authority to start, stop, and alter an individual PCAOB enforcement action. *See, e.g., Free Enterprise Fund*, 561 U.S. at 504-05. And had this proceeding been rife with the gross abuses claimed by Laccetti, the Commission could also have taken steps to remove unresponsive Board members for "willful abuse of authority" (*id.* at 503). Yet, as the hearing officer noted, despite the fact that, during the stage of this proceeding that preceded the Supreme Court's decision, the Commission "could have appointed a new Board majority, including a Chairman, because the Board Chairman position [was] vacant and the terms of two other Board members [had] expired," the SEC instead "withheld making new appointments." R.D. 138 at 3.

We thus reject Laccetti's contention, whether termed a facial or an as-applied challenge, that this proceeding must be dismissed on separation of powers grounds.

C. Taxation Power

As pertinent here, Section 109(d) of the Sarbanes-Oxley Act, 15 U.S.C. 7219(d), empowers the Board to establish and charge issuers "a reasonable annual accounting support fee...as may be necessary or appropriate to establish and maintain the Board." Laccetti argues that the support fee is a tax and that Congress impermissibly delegated its authority to the Board to levy such tax. R.D. 204 at 22-26; R.D. 210 at 5. We agree with the Division and the initial decision (I.D. 90) that Laccetti waived this affirmative defense by not timely raising it and that, in any event, the defense has no merit.[39/]

Board Rule 5421(c) requires a respondent to assert any "matter constituting an affirmative defense" in his or her answer, and it is undisputed that Laccetti's challenge to the fee provision is an affirmative defense. "It is a frequently stated proposition of virtually universal acceptance by the federal courts that a failure to plead an affirmative defense as required by Federal Rule [of Civil Procedure] 8(c) results in the waiver of that defense and its exclusion from the case." *See* 5 C. Wright & A. Miller, Fed. Prac. & Proc. § 1278 (3d ed.). That proposition applies even to defenses that might be characterized as purely legal in nature. *See, e.g., J & J Sports Prods. v. Delgado*, 2013 U.S. Dist. LEXIS 91447 at *13 (E.D. Cal. June 28, 2013) (defense "must be articulated to such a degree that the plaintiff is not subject to unfair surprise") (citing *Woodfield v. Bowman,* 193 F.3d 354, 362 (5th Cir. 1999)). Courts considering whether affirmative defenses have been waived are concerned not only about prejudice to the parties asserting the defenses but also about the resources of litigants and tribunals that might be wasted on lengthy proceedings unless parties are required to properly raise their defenses.[40/] The SEC, while recognizing that Federal Rule of Civil Procedure 8(c) does

[39/] We assume, for purposes of this opinion, that Laccetti has standing to make this challenge. As the Division points out, the initial decision held that Laccetti lacked standing because he was not an issuer, from whom the support fee is collected, but an associated person of a registered firm that audits issuers. I.D. 90. But neither the initial decision nor the Division has addressed Laccetti's theory that he has standing because if the fee provision is held unconstitutional, and is not severable from the rest of Title I of the Sarbanes-Oxley Act, *see generally Alaska Airlines, Inc. v. Brock*, 480 U.S. 678, 684 (1987), he would enjoy complete relief from this enforcement proceeding, *see generally Fed. Election Comm'n v. NRA Political Victory Fund*, 6 F.3d 821, 824 (D.C. Cir. 1993).

[40/] *See, e.g., Robinson v. Johnson*, 313 F.3d 128, 137 (3d Cir. 2002) ("Affirmative defenses must be raised as early as practicable, not only to avoid prejudice, but also to promote judicial economy. If a party has a successful affirmative defense, raising that defense as early as possible, and permitting a court to rule on it, may terminate the proceedings at that point without wasting precious legal and judicial resources."); *Bradford-White Corp. v. Ernst & Whinney*, 872 F.2d 1153, 1160-61 (3d Cir. 1989) (where defendant "did not file a motion or present argument before the district court on not apply to Commission proceedings, has nonetheless looked to it for guidance in holding that an affirmative defense is waived if not raised in a timely fashion. *See Russell Ponce*, SEC Rel. No. 34-43235, 2000 WL 1232986 at *11 & nn.53-54 (Aug. 31, 2000) (statute of limitations), *aff'd*, 345 F.3d 722 (9th Cir. 2003). In the interests of fairness and economy of the adjudication process—benefits that would accrue to all involved in Board proceedings—affirmative defenses should be timely raised.

Laccetti claims he raised the tax issue at the end of his answer to the OIP as his "Eighth Affirmative Defense." That defense merely asserted, "The proceedings instituted against Mr. Laccetti are invalid because the establishment and structure of the PCAOB violates the U.S. Constitution." R.D. 10 at 13 (omitting appended footnote: "Mr. Laccetti reserves the right to amend his Answer and interpose additional affirmative defenses as appropriate."). In a March 4, 2010 pre-hearing conference, his counsel construed that defense as raising "the issues that are related to the case now pending before the Supreme Court [in *Free Enterprise Fund*]," namely, "these issues" "about the structure of the PCAOB and the power of the president to appoint and remove board members," and construed it again, in moving on to discuss other affirmative defenses in the answer, by saying, "separate and apart from the issues before the Supreme Court, what we want to do is really raise issues related to the rights that we think should be afforded by the rules of the PCAOB to all respondents." R.D. 29 at 11-13. No mention was made of the support fee provision. It was not before the Supreme Court; challenge was made there only to the provisions for appointment and for-cause removal of Board members by the Commission. 561 U.S. at 487-88.

Furthermore, on June 28, 2010, the first scheduled day of the hearing, Laccetti's counsel successfully requested a one-day postponement because the Supreme Court had decided *Free Enterprise Fund* that morning. The next day, counsel made an oral application to the hearing officer to dismiss the case on the basis of the Court's decision and, failing that, for "expedited interlocutory appeal under PCAOB [Rule] 5461," asserting that Laccetti was "going to suffer irreparable harm by having to go through this proceeding when the whole proceeding in itself was the by-product of unconstitutional decisionmaking"; contending that "this issue certainly involves a controlling question of law"; and recognizing that "it was very important to make this application as soon as possible." R.D. 134 at 8-9; R.D. 135 at 29, 35-37. Laccetti now characterizes the support fee provision as an even more fundamental defect in the statute: "Unlike the [removal] provision at issue in *FEF*, Sarbanes-Oxley is not 'fully operative as a law' with the funding provisions excised." R.D. 204 at 26 n.35. Yet he failed to articulate a constitutional challenge in terms of the fee provision or Congress's taxation authority until his October 29, 2010 post-hearing submission. *See* R.D. 180 at 115-18. Under the circumstances of this case, Laccetti waived that defense by failing timely to raise it.

the statute of limitations issue [raised in its answer] at any time before or at the trial," but tried to argue issue in post-trial brief, finding "it would be grossly unfair to allow a plaintiff to go to the expense of trying a case only to be met by a new defense after trial").

Even if Laccetti had properly raised the defense, however, it fails on the merits. The Board's congressional authorization to collect a support fee is not unconstitutional because, quite simply, the fee is not a tax within the meaning of the Constitution. Article I, Section 8 of the Constitution grants exclusively to Congress the "power to lay and collect taxes," which may not be delegated without meeting certain minimum constitutional requirements. *Skinner v. Mid-Am. Pipeline Co.*, 490 U.S. 212, 223 (1989). Not all levies authorized by Congress, however, are taxes. In 1884, the Supreme Court held that a fee collected from all ship owners for each non-citizen passenger entering the United States was not a tax under Article I, Section 8. *Head Money Cases (Edye v. Robertson)*, 112 U.S. 580 (1884). The Court explained that the statute authorizing the fee designated the money to "defray the expense of regulating immigration," not for "the general support of the government," and was not an exercise of Congress's taxing power; instead, the fee was "the mere incident of the regulation of commerce" and well within the authority of Congress to impose. *Id.* at 590, 595-96.

Courts have continued to recognize this distinction between taxes and fees in analyzing constitutionality under Article I, stressing the fundamental difference between monies raised for general government use and those for regulation. For example, the Ninth Circuit held that a state levy imposed on railroads doing business in the state was not an unconstitutional tax. *Union Pac. R.R. Co. v. Public Util. Comm'n*, 899 F.2d 854, 859 (9th Cir. 1990) (citing *Head Money Cases*). In so holding, the court explained that "the concerns underlying the constitutional limitations imposed on the taxing power by article I, section 8 are relevant to measures having the primary objective of raising revenues for the general support of government, but not to measures having the primary objective of regulating commerce." When a statute serves the limited fiscal purpose of defraying costs related to a regulatory program rather than raising general revenues, a levy does not run afoul of Article I. *Id.; Chicago & N.W. Transp. Co. v. Webster Co. Bd. of Supervisors*, 880 F. Supp. 1290, 1306 (N.D. Iowa 1995) (a fee is not a tax unless it generates revenue "to offset unrelated costs or confer unrelated benefits" (emphasis in original) (citing *Digninet, Inc. v. Western Union ATS, Inc.*, 958 F.2d 1388, 1392-93 (7th Cir. 1992)). A number of other courts have reached the same conclusion. *See South Carolina ex rel. Tindal v. Block*, 717 F.2d 874, 887 (4th Cir. 1983) ("If regulation is the primary purpose of a statute, revenue raised under the statute will be considered a fee rather than a tax."); *United States v. Stangland*, 242 F.2d 843, 848 (7th Cir. 1957) (quoting *Rodgers v. United States*, 138 F.2d 992, 994-95 (6th Cir. 1943) ("The imposition with which we are concerned has for its object the fostering, protecting and conserving of interstate commerce and the prevention of harm to the people from its flow. It is not a charge on property for the purpose of raising revenue.")).[41/]

[41/] *See, e.g., San Juan Cellular Tel. Co. v. Public Serv. Comm'n*, 967 F.2d 683, 685 (1st Cir. 1992) ("Courts have had to distinguish 'taxes' from regulatory 'fees' in a variety of statutory contexts. Yet, in doing so, they have analyzed the legal issues in similar

Laccetti addresses none of this authority. The only case he cites in support of his claim that the support fee is a tax is of no help to him. The case's discussion of taxes and fees was geared to the distinctive statute and type of fee at issue there, which are very different from those at issue here.[42/] The Board's support fee, which, as pertinent here, is collected from public companies and which defrays the cost of overseeing the audits of those companies, is not a tax within the meaning of Article I.

Finally, even if the support fee were a tax, Laccetti acknowledges that there would be no constitutional problem unless Congress improperly delegated its taxing power to the PCAOB. R.D. 204 at 23. The Constitution only permits delegation where

ways. They have sketched a spectrum with a paradigmatic tax at one end and a paradigmatic fee at the other. The classic 'tax' is imposed by a legislature upon many, or all, citizens. It raises money, contributed to a general fund, and spent for the benefit of the entire community. The classic 'regulatory fee' is imposed by an agency upon those subject to its regulation. It may serve regulatory purposes directly by, for example, deliberately discouraging particular conduct by making it more expensive. Or, it may serve such purposes indirectly by, for example, raising money placed in a special fund to help defray the agency's regulation-related expenses.") (citations omitted).

[42/] Specifically, the statute at issue in *National Cable Television Association, Inc. v. United States*, 415 U.S. 336, 340 (1974), authorized federal agencies to collect a "fee, charge, or price" for any "work, service,...benefit,...license,...or similar thing of value" that is "granted, prepared, or issued by" them "to or for any person," considering, among other things, "the value to the recipient" and "public policy or interest served, and other pertinent facts." The Court noted that: (1) the specific wording about "benefit" or "value" to the payer, as informed by legislative intent, was inconsistent with a tax; (2) a "public agency performing those services" relevant to the statute "normally may exact a fee for a grant, which, presumably, bestows a benefit on the applicant, not shared by other members of society"; and (3) "[t]he words 'public policy or interest served, and other pertinent facts,'" which, "if read literally," might, in its "ultimate reach," "bestow on a federal agency the taxing power," did "not seem to be relevant to the present case." Accordingly, the Court resolved the "contrast[ ]" in language and "read the Act narrowly" to permit agencies to collect only fees that represent the value of a service received by the fee payer. *Id.* at 341-44. As courts have recognized, the case "was not announcing universal definitions of 'tax' and 'fee'" but instead was addressing "a particular context," one quite different from that in which regulation is a statute's primary purpose. *Union Pacific*, 899 F.2d at 861; *accord, e.g., San Juan Cellular*, 967 F.2d at 686 (distinguishing *National Cable* as focused on a statute that required evaluating whether the fee at issue provided "value to the recipient" and holding that "money [that] is not used for a general purpose but rather to defray[ ] the expenses generated in specialized investigations and studies, for the hiring of professional and expert services and the acquisition of the equipment needed for the operations provided by law for the [agency]" is not a tax).

Congress "shall lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform." *Hampton & Co. v. United States*, 276 U.S. 394, 409 (1928). Laccetti bears the burden of showing that this standard was not met. *Yakus v. United States*, 321 U.S. 414, 426 (1944). Contrary to Laccetti's unsupported assertion (R.D. 204 at 24 n.33), the standards of a delegation of power must be examined not "in isolation," but also by deriving "'meaningful content from the purpose of the [statute], its factual background and the statutory context.'" *Florida Power & Light Co. v. United States*, 846 F.2d 765, 776 n.9 (D.C. Cir. 1988) (quoting *American Power & Light Co. v. SEC*, 329 U.S. 90, 97 (1946)). And also contrary to his conjecture (R.D. 204 at 23), "'the delegation of discretionary authority under Congress' taxing power is subject to no constitutional scrutiny greater than that…applied to other nondelegation challenges.'" *Rural Cellular Ass'n v. FCC*, 685 F.3d 1083, 1091 (D.C. Cir. 2012) (quoting *Skinner v. Mid-America Pipeline Co.*, 490 U.S. 212, 223 (1989) and citing *Whitman v. American Trucking Ass'ns*, 531 U.S. 457, 472 (2001)).

Sarbanes-Oxley Act Section 109(d)(1) provides that the support fee is to "establish and maintain the Board." 15 U.S.C. 7219(d)(1). Section 101 provides that the PCAOB is established "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports." 15 U.S.C. 7211(a). Sections 102 through 106 describe the Board's ongoing responsibilities for registration, for auditing, quality control, and independence standards and rules, for inspections, for investigations and disciplinary proceedings, and with regard to foreign public accounting firms. 15 U.S.C. 7212-7216. Section 109(d)(2) calls for "the equitable allocation, assessment, and collection" of the support fee "among issuers, in accordance with subsection (g)," which provides that any amount due from issuers "shall be allocated among and payable by each issuer (or each issuer in a particular class, as applicable) in an amount equal to the total of such amount, multiplied by a fraction" based on "average monthly equity market capitalization" for a particular 12-month period of the issuer compared to all such issuers. 15 U.S.C. 7219(d)(2) & (g). Considered as standards for delegation, these are more than sufficiently precise to satisfy the Constitution. *See, e.g., Florida Power & Light*, 846 F.2d at 775-76 (cataloguing very general delegations upheld by the Supreme Court).

We therefore reject Laccetti's constitutional challenge to Section 109(d).

VIII.

Sarbanes-Oxley Act Section 105(c)(4) authorizes the Board to impose "such disciplinary or remedial sanctions as it determines appropriate," subject to certain limitations, on registered public accounting firms or associated persons of such firms if the Board "finds, based on all of the facts and circumstances," that the firm or person has violated PCAOB rules and auditing standards. 15 U.S.C. 7215(c)(4). With respect to a proceeding against an associated person, such as here, Section 105(c)(5) specifies that a suspension, bar, or limitation on the activities or functions of such person, as well as civil monetary penalties in excess of $100,000, "shall only apply" to "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard" or to "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." 15 U.S.C. 7215(c)(5). In this context, recklessness "represents an 'extreme departure from the standards of ordinary care,…which presents a danger' to investors or the markets 'that is either known to the (actor) or is so obvious that the actor must have been aware of it.'" *S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 SEC LEXIS 1954 at *77 (July 3, 2013) (citation omitted). Applicable PCAOB auditing standards provide the standard of care for assessing the auditor's conduct. *Id*.

The Board's determination of appropriate sanctions is guided by the purpose for which it was established: "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." *See* Sarbanes-Oxley Act Section 101(a), 15 U.S.C. 7211(a); *see also* Section 101(c)(5), 15 U.S.C. 7211(c)(5) (in identifying duties of Board, referring to objective "to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof" or "otherwise to carry out this Act, in order to protect investors, or to further the public interest"). In making this determination, the Board also draws guidance from the grounds on which the Act authorizes the Commission to disturb Board sanctions: a finding, with "due regard for the public interest and the protection of investors," that the sanction "is not necessary or appropriate in furtherance of this Act or the securities laws" or "is excessive, oppressive, inadequate, or otherwise not appropriate to the finding or the basis on which the sanction was imposed." Section 107(c)(3), 15 U.S.C. 7217(c)(3).

Furthermore, this statutory sanctioning authority was fashioned specifically to apply in actions to enforce compliance with the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the related obligations and liabilities of accountants, by registered public accounting firms and their associated persons. We therefore exercise that authority not only with fidelity to the particular language of the statute that created it but also ever-mindful of the particular role of the auditor.

As the Supreme Court has explained, "[b]y certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility"—a "special" "'public watchdog' function" of "a disinterested analyst charged with public obligations." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (emphasis in original). Other court cases have recognized "the particularly important role" played by auditors in "certifying the accuracy of financial statements of public companies that are so heavily relied upon by the public in making investment decisions," pointing out that "the confidence of the investing public in the integrity of the financial reporting process" and in the reliability of financial information, needed "[f]or the market to operate efficiently—indeed, for it to operate at all," is "bolstered by the knowledge that public financial statements have been subjected to the rigors of independent and objective investigation and analysis." *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005); *Marrie v. SEC*, 374 F.3d 1196, 1200-01 (D.C. Cir. 2004). As another court observed, "[b]reaches of professional responsibility" by members of the accounting profession "jeopardize the achievement of the objectives of the securities laws" and "can inflict great damage on public investors." *Touche Ross & Co. v. SEC*, 609 F.2d 570, 580-81 (2d Cir. 1979). The Commission and investors "'rely heavily on accountants to assure corporate compliance with federal securities law and disclosure of accurate and reliable financial information.'" *Dearlove*, 2008 SEC LEXIS 223 at *108 (citation omitted). While an auditor is "not a guarantor of the accuracy of financial statements of public companies," the "investing public rely heavily on auditors to perform their tasks in auditing public companies diligently and with a reasonable degree of competence." *Wendy McNeeley, CPA*, SEC Rel. No. 34-68431, 2012 SEC LEXIS 3880 at *40 (Dec. 13, 2012) (internal quotation marks omitted); *see* AU § 230.10, .13 (the auditor "is not an insurer and his or her report does not constitute a guarantee," but it "is based on the concept of obtaining reasonable assurance," through the exercise of due professional care, that "the financial statements are free of material misstatement, whether caused by error or fraud"). Thus, an audit is an important line of defense against unreliable financial information that harms the markets and investors.

The seriousness with which Congress viewed the audit role is indicated by the sanctions it authorized the Board to impose in auditor disciplinary proceedings under the Sarbanes-Oxley Act. Under the statute, available sanctions for a violation found by the Board could include the permanent revocation of a registered public accounting firm's registration, the permanent bar of a person's association with such a firm, and, for the period at issue here, per-violation civil money penalties of up to $750,000 for an individual and $15 million for a firm. Section 105(c)(4) & (5), 15 U.S.C. 7215(c)(4) & (5).

Having found, after careful review of the record, that Laccetti violated PCAOB rules and auditing standards, as previously discussed, we proceed to determine what sanctions are authorized under Sarbanes-Oxley Act Section 105(c) and are otherwise appropriate for that conduct. We first address the main violations and, after that, the failure to perform the retrospective review, in violation of AU § 316.64.

A. Sanctions Determinations for the Main Violations

1. Recklessness

Laccetti's conduct that resulted in his violations of AU §§ 150, 230, 326, 329, 333, and 342 was an extreme departure from the standard of care and presented a danger to investors and the markets that was either known to him or was so obvious he must have been aware of it. That pattern of conduct went far beyond merely making mistakes or errors in judgment. The Commission has described recklessness as "an egregious refusal to see the obvious or investigate the doubtful," exemplified by an auditor who "held his nose, closed his eyes, and signed off on the audit report, even though the circumstances" plainly required substantial additional audit work and evidence and may even have required a qualified opinion or a disclaimer of opinion. *See Barrie C. Scutillo*, 56 SEC 714, 2003 WL 21738818 at *9 (July 9, 2003), quoted in *Hatfield*, 2013 SEC LEXIS 1954 at *80. We conclude that Laccetti's conduct reached that level. And in acting in that way, Laccetti put investors at risk.

Laccetti was the auditor with final responsibility for the 2004 Taro USA audit. In both planning and conducting the audit, Laccetti recognized that there were serious questions about the adequacy of Taro USA's year-end 2004 sales allowance reserves. The company's use of sales allowances was integral to the type of company it was and to the accounting and auditing issues it generated. *See, e.g.*, R.D. 137 at 749-52. As the principal auditor's engagement partner pointed out, "[t]here is no manufacturing" at Taro USA, "90 percent of [the parent company's] sales are there," and "revenues and the AR allowances" is "a fundamental issue…in its operations." R.D. 141 at 1458-59; *see* Ex. J-17 at 29, 47. As the partner further observed, whether the product price was fixed or determinable at the time of sale, given sales allowances, is the most significant issue for revenue recognition in the pharmaceutical industry. R.D. 142 at 1800-01.

The risk of material misstatement of Taro USA's sales allowance reserves was not a latent issue. From the start of the 2004 audit, Laccetti's attention was specifically directed to that risk. The unusual, dramatic drop in second-quarter sales and the discovery of the extensive chargebacks overpayments strained an estimation process the auditors already did not regard as strong. According to Laccetti, he was well aware of the risk of material misstatement and "created [the 2004] audit plan with the hope of gaining as much information from Taro US as possible" about those reserves. R.D. 135 at 273-74; R.D. 180a at 61. During the field work, he expressed concerns to Taro USA and the principal auditor about the reserves, initially determined that the support offered for them was inadequate, requested additional evidence, and for the rest of the audit continued to view the "AR" issue as "tough." Unlike with the other individual reserves, management did not provide any calculations to support the part of the overall reserves represented by chargebacks or even a clear explanation of how it had been determined. Audit testing showed a striking and ill-explained drop in that part of the reserves, which had represented 45% of the total only the year before, and also showed a substantially worsening cash collection problem that could signal inadequate reserves.

Yet Laccetti did not employ sufficient professional care, including heightened professional skepticism. Instead, he acquiesced in management's view that it was too difficult to match any chargebacks and sales and to provide a detailed calculation for that reserve, abandoned any plans to subject that part of the reserves to direct, detailed audit testing, such as he otherwise used in the high-risk area of sales allowance estimates, accepted an insupportable explanation for the steep drop in the chargebacks reserve, selectively adjusted 2004 days sales in accounts receivables downward, and relied exclusively on that and other overly general, inapt, or flawed procedures, repeatedly involving untested management assertions, as the only testing for that part of the reserves. With evident hesitation, Laccetti then expressed an unqualified opinion to the principal auditor.

Laccetti could not have failed to appreciate that acceptance of Taro USA's total year-end 2004 accounts receivable reserves balance under these circumstances presented a danger to those relying on rigorous, objective audit inquiry and analysis. He knew that Taro USA's parent company was publicly traded on the NASDAQ National Market and reported its consolidated financial statements in SEC filings. He also knew that Taro USA made most of the parent company's sales. R.D. 135 at 197. Indeed, since at least 2002, more than 85% of the parent company's recorded consolidated net sales and more than 90% of its recorded consolidated year-end net accounts receivable and accounts receivable reserves came from Taro USA. And Laccetti knew that chargebacks was by far Taro USA's single largest sales adjustment at year end 2003 and 2004 and the largest component, again by far, of its year-end 2003 accounts receivable reserves, before the chargebacks reserve plummeted by year end 2004 for reasons he has never been able to explain or justify.

Laccetti's arguments that he did not act recklessly are based almost entirely on his view that he did not violate the pertinent PCAOB standards in the first place, a view we have rejected for reasons previously discussed. Nothing in the "context in which the 2004 Taro USA engagement took place"—"prior to the point when [the parent company] had to adopt the sweeping internal control reforms that were ushered in with the Sarbanes-Oxley Act of 2002" (R.D. 204 at 3, 26)—excused Laccetti's disregard of some of the most basic auditing principles. These were principles such as exercising due professional care, including maintaining an attitude of professional skepticism, obtaining sufficient competent evidential matter to afford a reasonable basis for an opinion, and performing audit procedures that are appropriate for the risks of material misstatement.

Laccetti also argues that he "did not act with a reckless state of mind when considering" the part of the accounts receivable reserves balance represented by chargebacks because he undertook "extensive testing" of the other "components of the accounts receivable reserve," which he assessed individually, "as well as other aspects of the Taro USA audit engagement," including "a short-dated inventory issue, a computer system issue, a complex licensing agreement, tax issues, and a barter transaction." R.D. 204 at 26-27. A general inference such as he asks us to draw from other audit work cannot overcome what the ample, detailed, and direct evidence about the audit work at issue shows, namely that the latter was seriously deficient and posed an obvious danger. Briefs merely multiplying citations to unrelated or insufficient audit work do not change the fact that Laccetti "look[ed] the other way despite suspicions" (*Marrie*, 374 F.3d at 1204) in the audit work we are discussing here. *See Dearlove*, 2008 SEC LEXIS 223 at *106 (evidence that an auditor "spent substantial time and effort on some auditing areas does not insulate him from liability for his failure to spend enough time and effort" on another area "so material to" the financial data under audit).

We recognize that Laccetti's prior experience auditing pharmaceutical companies was limited to serving as senior manager on the 2003 Taro USA audit. And he asserts that his 2004 audit "'strategy was similar to that of the prior year'" in assessing the part of Taro USA's sales allowance reserves balance represented by chargebacks through procedures on the total reserves balance. R.D. 180 at 93 (quoting investigative testimony of senior manager); R.D. 180a at 175. Indeed, at times, Laccetti's hearing testimony reads as if he merely copied language from 2003 Taro USA audit documents for the 2004 audit (*see, e.g.*, R.D. 135 at 281-82, 380-84), and reliance on the 2003 audit is a frequent refrain in the senior manager's investigative testimony (Exs. L-181 at 36-37, 48-52, D-303 at 20, 27, 42-51, 57-58, 81-82, 161, 165-66).

Laccetti was, however, an experienced auditor. After graduating from college in 1989, Laccetti worked for 11 years at Ernst & Young as a staff accountant, senior accountant, manager, and senior manager. After transferring for three years to the firm's business risk services group, he returned to the audit practice in December 2003, and was promoted to partner, effective July 1, 2004. R.D. 137 at 661-64, 667; I.D. 15. Whatever strategy he employed in the 2004 Taro USA audit, he needed to effectively respond to the combination of circumstances he faced. He accepted the role of auditor with final responsibility for that audit, and he claims to have exercised his professional judgment and appreciated and addressed the risks presented by Taro USA's accounts receivable reserves, auditing around the difficulties he faced. And we note that he does not claim, nor does the record show, that he sought any assistance in resolving what he acknowledges was the "tough" and "problematic" area of Taro USA's 2004 accounts receivable reserves from the long-serving engagement partner who preceded him in that role on the Taro USA audits, independent reviewer on the audit, or principal auditor, or more generally from his firm's professional practice group, consisting of "partners and senior managers throughout the firm who are available to assist and consult with" an audit team (R.D. 139a at 964-66). Interestingly, Laccetti points out to us in his brief that, in an unrelated area of the audit, he "required Taro USA to record a $2 million adjustment" to its short-dated inventory reserve (R.D. 204 at 27 & n.36), yet he indicated in his testimony that this was an area in which he was in "consultations…with our professional practice group" about an "inventory analysis" (R.D. 139a at 950).

By contrast, Laccetti kept deliberations about the adequacy of Taro USA's 2004 accounts receivable reserves within the 2004 audit team. It was a team that had changed around Laccetti since the prior year. It had two other members. One was a senior manager who testified in the investigation that he joined Ernst & Young in October 2004, after some experience at two other audit firms, and "expressed reservations [to Lacetti] about working on a public client since I didn't have any experience" with audits of public companies or pharmaceutical companies. Ex. D-303 at 7-16. The senior manager had "very minimal work with respect to revenue recognition," limited to "[r]ecruiting and personnel firms, mostly service related." *Id.* at 9-11; *see id.* at 96-97, 105-07, Ex. D-315 at 4 (further references by senior manager to his lack of experience). And the senior manager thought it was responsive to the Israeli engagement partner's question about whether Laccetti was completely satisfied with the existing level of Taro USA's reserves simply to refer to the Summary Review Memorandum and remark to Laccetti, "I think we are as comfortable as we can get." Ex. D-256 at 1; Ex. D-98. The last team member was a staff accountant who Laccetti testified had been with Ernst & Young for two years, had some prior experience, but "didn't have the same level of experience" as the senior auditor on the 2003 audit, and served as "acting senior" auditor. R.D. 137 at 707; R.D. 139a at 1009-11.

In spite of all of this, Laccetti reported ultimate satisfaction with the total sales allowance reserves balance. And he did so in summary memoranda that used language consistently suggesting that audit procedures were more substantial and extensive than they were. *See* pp. 19, 23, 49, 50, 60-61 above. Ultimately, faced with a deadline for completing the audit, Laccetti had to choose between signing off on the audit or continuing to press his questions and concerns about the sales allowance reserves. Investor interest required the latter, but Laccetti chose the former. In violating AU §§ 150, 230, 329, 326, 333, and 342, as we have found, Laccetti acted recklessly.

2. Sanctions

For violations such as those found here, the Sarbanes-Oxley Act calls on the Board to determine and impose appropriate sanctions, within specified parameters. In determining appropriate sanctions, we consider the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, all through the lens of our statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports.

Laccetti's reckless conduct ill-served the investor interests and public interest that an audit should serve, falling far short of the rigorous, objective inquiry and analysis required by PCAOB standards. Taro USA's year-end 2004 sales allowance estimates played a key role in the company's recognition of revenue and its valuation of approximately 40% of the current assets on its balance sheet. *See, e.g.,* Ex. D-125 at 15. Laccetti's audit assessment of the reasonableness of that significant accounting estimate was seriously deficient. The deficiencies extended to the manner in which procedures were performed and evidential matter was evaluated and the sufficiency of the minimal audit evidence obtained that bore on the part of total sales allowance reserves for which Taro USA did not provide a detailed calculation or explanation. The deficiencies affected what had in the prior year been 45% of the total estimate and rendered illusory the assurance apparently provided by Laccetti's sign-off on Taro USA's 2004 financial information. His violations form a pattern of conduct in the audit in which, as the initial decision observed (I.D. 74), Laccetti appears to have ended up simply searching for some basis on which to accept the total sales allowance reserves balance, regardless of whether he possessed sufficient competent audit evidence to do so. Such an approach is fundamentally at odds with the role of the independent auditor.

It is clear that Laccetti's conduct adversely impacted investors and the markets. Taro USA's financial results largely drove the performance of its parent company, whose common stock was publicly traded on the NASDAQ National Market and whose consolidated financial statements were reported in SEC filings. Laccetti's conduct resulted in an unjustified audit report on Taro USA that was then used by the principal auditor in issuing an unqualified opinion on the parent company's financial statements. This deprived investors and the public of the protection that a properly performed audit provides, in this instance protection that should have been an obstacle to the parent company filing financial statements that were so substantially misstated.

The sanctions we impose must protect against Laccetti's demonstrated capacity for the conduct at issue here and, contrary to his claim that this case represents mere "disagree[ment] with the judgments [he] made" (R.D. 204 at 27), must encourage more rigorous compliance by him and others with the principles that "an auditor must exercise, not his 'inclination,' but his 'professional judgment' and that judgment must be 'guided by sound' auditing principles, among which are a 'thorough…search for evidential matter,' AU § 326.23, and an 'attitude that includes a questioning mind and a critical assessment of audit evidence,' AU § 230.07" (*McCurdy*, 396 F.3d at 1263).

We cannot assume, as Laccetti essentially asks us to do, that, despite the type of conduct in which he engaged, he poses no continuing risk of harm to those who trust to the reliability of issuer audit reports. He argues that his violations were "isolated to a single component of an overall reserve during a single audit"; that the audit was one of his first as an engagement partner; that he has an "otherwise unblemished professional career as an accountant and auditor"; that he left Ernst & Young for a regional accounting firm, where he is a partner in "the corporate governance and risk management department" and "does not perform public company audits or any audits of financial statements of companies, public or private"; and that he "has not performed a public company audit since the 2004 Taro USA engagement" and has "no intention of doing so in the future." R.D. 204 at 29-30; R.D. 210 at 3-4; R.D. 180 at 6-7.

Laccetti's misconduct was extremely serious. The more serious a violation, the stronger the inference that it will be repeated. *See generally Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004). His point that the violations involved a single assessment in one area of a 2004 audit, rather than multiple audits, areas, or assessments, does not capture the fuller picture. Among other things, the assessment was highly important, it was in a key audit area, it involved a particular need to press the client and insist on a properly informed and rigorous audit evaluation, relating as it did to a sales allowance estimate based on a deficient process and lacking any detailed calculation or specific explanation, and it fell far short of compliance with PCAOB auditing standards.

Although he had only recently been promoted to engagement partner, did not have prior experience leading a pharmaceutical company audit, and faced particular challenges due to Taro USA's lack of a formalized process for estimating sales allowances and difficulty providing information about the estimates, he accepted the role of engagement partner on the audit, was an experienced auditor and had prior experience with the client when he committed the violations, claims to have appreciated and responded to the risks in that audit area, and did not seek assistance from more experienced auditors on the admitted difficulties and problems he encountered in that area. According to Laccetti, he has no track record of auditing public company financial statements since the 2004 audit or of auditing any company's financial statements since March 2009.

Laccetti highlights that he initially expressed to management and the principal auditor an unfavorable view about the level of Taro USA's 2004 sales allowance reserves and requested further support for the amount and that some detailed audit work was done on the individual accounts receivable reserves other than chargebacks. And, according to Laccetti's testimony, he made an effort in the 2004 audit to improve procedures by trying to download information from Taro USA's accounting system onto an audit software tool so that he could "manipulate that information," "create lags," "pull out various accounts" and "look at complete populations of data," but had to "abandon that approach because they just could not provide us the information in readable data for our audit tools." R.D. 139a at 886-88. Those actions appear to reflect an appropriate audit approach, but whether in the larger context here they ultimately redound to Laccetti's credit is a different question. In fact, these indications of his focus on the problem and his apparent competence in recognizing that he needed to do more to address it, make his ultimate acceptance of the total reserves all the more troubling.

Furthermore, as the Division reasons, Laccetti's "current intentions are not enforceable," and his "occupation provides him with ample opportunity to commit future violations, as he remains a CPA, employed by a registered public accounting firm, with many more years of practice ahead of him," at 47 years old. R.D. 215 at 2; *see* R.D. 180 at 5; R.D. 135 at 192. Previously in his career, he returned to an audit practice after devoting several years to the same kind of work he says he has done since leaving Ernst & Young. R.D. 137 at 660-67. The record does not support a conclusion about the factors and motivations that shaped his career decisions or that would likely affect them if this proceeding were resolved, as he urges, with no more than a "de minimis" sanction. Laccetti has shown no recognition of the wrongful nature of his conduct, and we have no assurance that he would respond differently if faced with similar circumstances in a future issuer audit, both of which he acknowledges are valid factors for us to consider. R.D. 210 at 2; *see, e.g., Horning v. SEC,* 570 F.3d 337, 346 (D.C. Cir. 2009); *Seghers v. SEC*, 548 F.3d 129, 137 (D.C. Cir. 2008); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 100 (2d Cir. 1978); *Rita J. McConville*, SEC Rel. No. 34-51950, 2005 SEC LEXIS 1538 at *60 (June 30, 2005), *aff'd*, 465 F.3d 780 (7th Cir. 2006). Even if, as Laccetti claims, his "otherwise unblemished professional career" (R.D. 204 at 29 n.38) were a mitigating factor, it is not significantly mitigating overall.

See, e.g., Siegel v. SEC, 592 F.3d 147, 156-57 (D.C. Cir. 2010) ("an associated person should not be rewarded for acting in compliance with the securities laws and with his duties as a securities professional"); *Kornman v. SEC*, 592 F.3d 173, 187-88 (D.C. Cir. 2010); *Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006); *Dennis S. Kaminski*, SEC Rel. No. 34-65347, 2011 SEC LEXIS 3225 at *43 & n.35 (Sept. 16, 2011).[43/]

We have therefore determined to bar Laccetti from association with a registered public accounting firm but to provide that he may petition the Board to associate with such a firm after two years. We have also determined that a civil money penalty is appropriate to further impress on him the seriousness of his violations, which created a significant risk of substantial losses to investors, and deter him, as well as others who may find themselves in similar circumstances, from future such misconduct. Under the circumstances, we impose an $85,000 civil money penalty. Given the findings and basis on which these sanctions are imposed, they are far from excessive, contrary to Laccetti's contentions.[44/] Laccetti committed multiple violations, but this civil penalty is

[43/] The initial decision did not take the sanctions principles we have discussed properly into account. It also went beyond proper consideration of whether Laccetti's violations were isolated or recurrent. That is one inquiry, in determining sanctions, into the characteristics of the conduct that is the subject matter of the litigation. It is not a warrant to make broad assumptions, because "the OIP does not allege any deficiencies" in certain "other aspects of the 2004 Taro USA audit" considered by the decision to be "important," that his conduct in those unrelated other areas "indicates an adherence to PCAOB standards" and then affirmatively to place great weight on those assumptions in evaluating the conduct actually at issue. *See, e.g.,* I.D. 37-38, 61, 114.

[44/] In opposing sanctions, Laccetti discusses various litigated and settled cases cited by the Division. R.D. 210 at 4-7. The sanctions imposed here are not out of line with those cases or others that might be cited, including litigated Board cases in which the violation was noncooperation with a PCAOB investigation, in each of which the Board imposed a $75,000 civil money penalty, in addition to a permanent bar, and which did not present the developed record of auditing standard violations, and the particular concerns about investor protection, that are present here. *Cf., e.g., Dearlove*, 2008 SEC LEXIS 223 at *111 & n.120 (citing certain litigated SEC Rule 102(e) cases against auditors involving single-audit violations); *R.E. Bassie & Co.*, SEC Rel. No. 3354, 2012 SEC LEXIS 89 at *44, *47-*48 (Jan. 10, 2012) (litigated case of noncooperation with PCAOB investigation); *Kempisty & Co.*, SEC Rel. No. 34-65950, 2011 SEC LEXIS 4396 (Dec. 14, 2011) (settled 102(e) case); *Dohan + Co. CPAs*, SEC Rel. No. 34-63740, 2011 SEC LEXIS 247 (Jan. 20, 2011) (same); *Chaim Schwartzbard, CPA*, SEC Rel. No. 34-53725, 2006 SEC LEXIS 951 (Apr. 26, 2006) (same); *Michael Karlins, CPA*, SEC Rel. No. 34-49997, 2004 SEC LEXIS 1466 (July 9, 2004) (same); *David T. Thomson, CPA, CPA*, SEC Rel. No. 34-49516, 2004 SEC LEXIS 761 (Apr. 1, 2004) (same); *Randall A. Stone, CPA*, PCAOB Rel. No. 105-2014-007 (July 7, 2014)

at the low end of the range of the heightened civil penalties authorized by the Sarbanes-Oxley Act for each violation involving the level of misconduct found here and less than the maximum civil money penalty authorized by the statute for a single violation not even reaching that threshold.[45/]

(settled auditing standards case); *Ray O. Westergard, CPA*, PCAOB Rel. No. 105-2010-003 (Feb. 17, 2010) (same); *Williams & Webster, P.S.*, PCAOB Rel. No. 105-2007-001 (June 12, 2007) (same). In any event, the appropriate sanctions depend on the facts and circumstances of each specific case and cannot be determined precisely by comparison with other cases involving different circumstances. *Hatfield*, 2013 SEC LEXIS 1954 at *95. Comparisons to settled cases are particularly problematic because "'settled cases take into account pragmatic considerations such as the avoidance of time-and-manpower-consuming adversary proceedings'" and therefore those "'who offer to settle may properly receive lesser sanctions than they otherwise might have.'" *Id.* Here, we have made extensive findings about Laccetti's departures from the standards of care and carefully considered the public interest, based on a full, developed record.

[45/] Laccetti's suggestion is unfounded that a civil money penalty may only be imposed where an auditor engages in "fraud, deceit, manipulation, or an intentional disregard of a regulatory requirement," the auditor is "unjustly enriched as a result of his conduct," or there is "direct evidence" that "harm occurred or, if so, the extent of the harm" resulting from the violations. R.D. 210 at 3 (internal quotation marks omitted). As support, Laccetti cites a case involving noncooperation with a PCAOB investigation. *Id.* (citing *Larry O'Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 at 9-10 (Oct. 19, 2010)). In ordering a civil money penalty in that case, the Board considered factors that a statute authorizing the imposition of civil money penalties in proceedings instituted pursuant to certain sections of the Securities Exchange Act of 1934, typically against stockbrokers and investment advisers, stated that the SEC or the appropriate regulatory agency "may consider" (Exchange Act Section 21B, 15 U.S.C. 78u-2).

Those factors, all of which need not be present even in proceedings governed by that statute, include whether the misconduct "involved fraud, deceit, manipulation, or deliberate disregard of a regulatory requirement"; "[t]he harm to other persons resulting either directly or indirectly from" the misconduct; "[t]he extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior"; "[t]he need to deter such person and other persons from committing such" misconduct; and "such other matters as justice may require." In terms of harm, that statute does not require, even for the highest of the three "tier[s]" of civil penalties it allows, direct evidence of the occurrence and extent of harm but rather that the misconduct "created a significant risk of substantial losses to other persons" (15 U.S.C. 78u-2(b)(3)(B)), which certainly was true here. In auditor noncooperation cases, the Commission has affirmed the Board's holding that "'the absence of fraud or deceit does not…diminish the seriousness'" of the misconduct (*Gately & Associates*, SEC Rel. No. 34-62656, 2010 SEC LEXIS 2535 at *50 (Aug. 5, 2010)), and emphasized the

Accordingly, we impose an associational bar, providing that a petition to associate with a registered public accounting firm may be made after two years, and an $85,000 civil money penalty.[46]

B. Sanctions Determinations for Violation of AU § 316.64

Laccetti did not seek review of the initial decision's finding that he violated AU § 316.64 and PCAOB rules due to the lack of a retrospective review of Taro USA's 2004 accounts receivable allowances. AU § 316.64 provides that an auditor "should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year." With "the benefit of hindsight," that procedure "should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates." *Id.* Rule 3101(a)(2), in effect during the 2004 audit, explains that a standard that uses the word "should"—like AU § 316.64—imposes a responsibility that is "presumptively mandatory." This means that failure to discharge that responsibility "is a violation of the relevant standard and Rule 3100" unless the auditor "demonstrates that, in the circumstances, compliance with" that responsibility "was not necessary to achieve the objectives of the standard" and that "alternative actions he or she followed in the circumstances were sufficient to achieve [its] objectives." Rule 3101(a)(2). No such demonstration is at issue in this case. I.D. 77 n.33; *see, e.g.,* R.D. 180a at 217, 218.

The Division argues that Laccetti "skipped" the retrospective review despite knowing that it was presumptively mandatory; that it was specifically planned for the

"flexib[ility]" of Exchange Act Section 21B when used in such cases, identifying multiple additional considerations "not explicitly enumerated" in that statute (*Bassie*, 2012 SEC LEXIS 89 at *46-*47, *50-*51). Furthermore, Sarbanes-Oxley Act Section 105(c), 15 U.S.C. 7215(c), which governs our enforcement actions for violations of PCAOB auditing standards, authorizes civil penalties not only for "intentional or knowing conduct, including reckless conduct," but for "repeated instances of negligent conduct," as well as for conduct not even rising to that level.

[46] Even if Laccetti had not acted recklessly, he engaged, at a minimum, in repeated instances of negligent conduct, and the instances were sufficiently numerous and serious that we would determine that the same sanctions are appropriate. *See Hatfield*, 2013 SEC LEXIS 1954 at *97 n.169 ("given the scope of [the auditor's] repeated auditing failures" finding that sanctions were appropriate "regardless of whether [the auditor's] conduct is deemed to be knowing, reckless, or negligent"); *Dearlove*, 2008 SEC LEXIS 223 at *108 (noting that "'a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive'" and that "under some circumstances, unreasonable conduct is not necessarily a less egregious disciplinary matter than either intentional or reckless conduct") (citation omitted).

audit; and that Ernst & Young, through Laccetti, represented to the principal auditor and, through it, to Taro USA's parent company, that the procedure would be and had been performed. R.D. 205 at 14-15; R.D. 215 at 4. The Division challenges the hearing officer's conclusions—stated without explanation in a short footnote in the initial decision—that the violation was not proven to have "involved reckless conduct, as opposed to mere negligence" and that the sanctions imposed for the other violations "fully remediate Laccetti's misconduct, and, therefore, [the decision] impose[s] no additional sanctions" (I.D. 113 n. 50). R.D. 205 at 14-15; R.D. 215 at 4. Those statements are in tension with the sound reasons stated elsewhere in the initial decision for holding Laccetti liable for not having "confirmed that a retrospective review had been performed, and reviewed the results" (I.D. 77), and, due to commonalities with the other violations found, with the decision's and our discussion of those other violations.

The retrospective review was a presumptively mandatory procedure under AU § 316.64 and PCAOB Rule 3101(a)(2) that would have addressed the same high-risk area and scarcity of information in which the other violations occurred. More specifically, the Internal Control and Fraud Considerations document, approved by Laccetti and provided to the principal auditor, stated that, to address the identified fraud risk relating to biases in significant accounting estimates, the Ernst & Young audit team planned to "[p]erform detail testing and analytical review procedures, including hindsight review, of all significant accounting estimates." Ex. J-29 at 8. In the full scope conclusion, Laccetti represented to the principal auditor that Ernst & Young had performed a "full scope US GAAP and US GAAS audit" on Taro USA's financial information, understood by all to require an audit conducted in accordance with PCAOB standards. *See, e.g.,* Ex. D-126; Ex. J-2. And, when the principal auditor forwarded to Laccetti for his review a draft Audit Results and Communications presentation to the audit committee of Taro USA's parent company, Laccetti failed to correct the statement in the document that a retrospective review had been performed. Ex. D-266 at 1, 18; Ex. D-116 at 1-2; R.D. 137 at 527-30; *see* R.D. 180 at 95; R.D. 182 at 33.

As the hearing officer explained in finding the AU § 316.64 violation, "[t]he required retrospective review related to assessment of Taro USA's accounts receivable reserves, by providing information to assist in identifying possible management bias." I.D. 77. And "[b]oth in planning the audit and in performing the field work, Laccetti recognized serious issues regarding the reliability of Taro USA's reserves." *Id.* In otherwise imposing sanctions, the decision explained that Laccetti "did not fail to uncover a latent issue or misapply auditing or accounting standards—conduct that might be described as merely negligent. Rather, from the outset of the audit, [his] attention was specifically directed to the risk of a misstatement of Taro USA's reserves, and he planned the audit accordingly." *Id.* at 110. As to the other violations found, the decision concluded that Laccetti "must have known that his acceptance of the chargebacks reserve and total reserves including chargebacks," in spite of inadequate audit testing, "presented a danger to investors and the market." *Id.* at 112. The decision does not explain why that conclusion would not also apply to the failure to perform the retrospective review procedure. Indeed, the retrospective review, although "not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time" (AU § 316.64), could have provided important information, not available to the 2003 audit team, about the 2003 year-end sales allowance reserves, some 45% of which (the chargebacks portion, *see* Ex. L-22 at 2) lacked any detailed calculation or explanation from Taro USA, and which reserves Laccetti used as a reasonable expectation for the 2004 year-end reserves.

Nor is the explanation apparent from the circumstances of the 2004 Taro USA audit, which would only seem to have magnified the importance of the retrospective review. Specifically, as Laccetti knew from the principal auditor's management letter for 2003 to Taro's audit committee, Taro USA's parent company did not "have a formalized process and methodology for the establishment and maintenance of the significant financial statement accounts," including "accounts receivable reserves (allowances and accruals)," and, "[g]iven the potential importance for financial reporting purposes, formalizing policies and procedures related to these processes" would "provide consistent application from period to period." Ex. D-21 at 3. During the 2004 first-quarter review, Laccetti made reference to a "[n]eed to build 'look back' procedures into [the] A/R allowance process." Ex. D-24; R.D. 135 at 294-295.

In audit planning documents for the 2004 Taro USA audit, Laccetti identified "[m]anipulating significant accounting estimates," including "accounts receivable allowances," as one of three fraud risks; observed that Taro USA was subject to significant pric[i]ng pressures and low margins relating to generic pharmaceuticals that creates pressure to meet sales goals and "could lead to improper revenue recognition"; noted that its "accounts receivable allowance estimation process…still remains an area of significant subjectivity"; and developed three audit responses to the risk of management bias in Taro USA's significant accounting estimates: "[p]erform detail testing and analytical review procedures, including hindsight review, of all significant accounting estimates"; "[d]ocument our understanding of the client's processes and determine whether there appears to be any management bias"; and "[d]etermine whether management is consistently recording estimates." Ex. J-29 at 6, 8. Taro USA faced significant financial pressure in 2004, as it tried to help overcome "a substantial decrease" in the parent company's consolidated second quarter sales, from $84 million to $49 million, resulting in an $8.9 million loss, drop in the share price from around $60 to $20, and "several class action lawsuits"; as Taro USA's recorded net sales for the year "decreased approximately $35 million to $248 million"; and as it recorded a net loss of $33 million, down from $11 million in net income in 2003, and its "pre-tax net loss before taxes exceeded $52 million for 2004." Ex. J-26 at 3; Ex. D-125 at 1-2.

In the field, the audit team had difficulty obtaining information about the sales allowance estimates. Laccetti repeatedly expressed concerns about them. Taro USA did not specifically calculate or explain its chargebacks reserve, impacting at least the first two of Laccetti's three chosen audit responses to the risk of bias in the accounts receivable allowances. He abandoned his plan to directly test the chargebacks estimate, which was inconsistent with other financial data he was able to confirm. He stated at the time that "[o]ur accounts receivable analysis is not favorable" and that "we are not comfortable that the accounts receivable are fairly stated as currently presented." Ex. D-87 at 1. This "meant not hitting the original fieldwork completion date" and having to "expand[ ] our procedures to perform detailed substantive tests of individual accounts receivable to gain comfort that the amounts were properly recorded at net realizable value." Ex. J-9 at 5; R.D. 180 at 87. And when the principal auditor's engagement partner first questioned Laccetti about Laccetti's conclusion that the year-end accounts receivable reserves were reasonable, Laccetti responded with hesitation.

Moreover, Laccetti has claimed that during the 2004 audit he "wanted as much documentation and information as possible relating to Taro US's process for determining accounts receivable as a whole," sought "to extract as much data from Taro US as possible," and approached the adequacy of its total accounts receivable reserve based on "an assessment of the totality of evidence gathered over the course of the audit." R.D. 180 at 32; R.D. 180a at 61-62; R.D. 204 at 6 (emphasis in original). Yet the 2004 audit did not include a retrospective review of the sales allowance estimates.

Laccetti takes up this issue in his opposition brief on appeal, contending that "there is no evidence to suggest" that his AU § 316.64 violation was reckless and no need for "additional sanctions" because the "other imposed sanctions 'fully remediate [his] misconduct.'" R.D. 210 at 7-8 (quoting initial decision). He does not argue that the retrospective review could not be performed or that the procedure would not have been meaningful. Having stated in his answer to the OIP that, "to the best of [his] current knowledge, no such procedures [as a retrospective review] were performed" (R.D. 10 at 7), and testified at the hearing that he did not recall the review being done or documented in the audit (R.D. 135 at 383-95), he seems to reason on appeal that he could have thought that a retrospective review was done, even though that was not so, or that it is a matter of little consequence for sanctions purposes, due to other audit information he claims to have obtained about possible management bias.

In support of his position, Laccetti first cites a work paper captioned "Gross/Net Sales and Cash collection analysis, 12/31/2004." R.D. 210 at 7 (citing Ex. L-22 at 12). He argues that the "lag analysis" on that page was used to "compare the 2003 accounts receivable reserve to the subsequent collection of cash in 2004 related to 2003 sales," thereby resembling a retrospective review. *Id*. In finding the AU § 316.64 violation despite a similar argument, the initial decision noted that there was no supporting evidence that this other procedure was considered to be a retrospective review. I.D. 76. As the work paper itself, the email from the senior manager transmitting the lag analysis to Laccetti, and Laccetti's hearing testimony all indicate, the purpose of the analysis was to compute an amount of net accounts receivable "collected" in, and "still open" after, each quarter in 2004, "using the assumption that it takes 110 days to collect the average receivable," to support a management representation that there was a "slow down" in payments by Taro USA's three largest wholesalers. Ex. L-22 at 12; Ex. D-82 at 1, 6; R.D. 135 at 386-95. The analysis "basically shows that there is still $48 million in outstanding receivables as of December 31, 2004 that do not relate to the current quarter (older receivables)," up from $41 million in the first quarter and $39 million in the third quarter. Ex. D-82 at 1, 6 (senior manager's email); Ex. L-22 at 12. Even if, for that general purpose, using the imprecise 110-day assumption based on 2003's much faster pace of cash collections were justifiable, there is no indication that Laccetti considered whether it would have captured Taro USA's actual 2004 sales allowance claims experience well enough to serve as a retrospective review of the year-end 2003 reserves. The lag analysis work paper does not present, summarize, or analyze data in a way that serves the purpose of evaluating accounts receivable reserves for potential management bias. The lag analysis does not mitigate the AU § 316.64 violation.

Second, Laccetti asserts that the "analytical procedure comparing cash collections as a percentage of gross sales to net sales as a percentage of gross sales" for 2003 and 2004 (*see* Ex. L-22 at 1640)—on which he claims to have relied to test the reasonableness of the year-end sales allowance reserves under AU § 342—gave him "'comfort'" that Taro USA was "'doing a good job estimating allowances, as well as it didn't appear there were any biases.'" R.D. 210 at 7-8 (quoting his testimony). For the reasons discussed above, that audit work was too cursory to give any significant comfort that Taro USA was doing a good job estimating the allowances. Moreover, Laccetti has made clear he "is not asserting that" this work "is satisfying AU § 316.64." R.D. 180a at 218. Indeed, he does not cite anything in the work papers that purports to "demonstrate[ ] that alternative actions [the audit team] followed in the circumstances were sufficient to achieve the objectives of" AU § 316.64, which would have been required under Rule 3101(a)(2), had anyone believed that to be the case. *See* I.D. 77 n.33. The work papers do not suggest that the procedure he cites, which is not discussed in any of the summary memoranda, was done to assess management bias. Simply performing some other procedure would not provide a basis for thinking that the retrospective review was unimportant. PCAOB standards envision that auditors will do other procedures to assess potential bias in management estimates in addition to a retrospective review. *See, e.g.*, AU §§ 312.36 (quoted in 342.14), 342.04, 342.09.

Finally, Laccetti argues that the senior manager "signed off on the team's summary of procedures performed indicating that a retrospective review had been performed" and that, as the audit partner, Laccetti "'is entitled to rely on those preparing and initially reviewing the working paper'" and is "'not expected to recalculate amounts or replicate procedures.'" R.D. 210 at 7, 8 n.4, citing Ex. L-103 at 11 and quoting Ex. L-179 at 43 n. 142 (his expert's report). Again, the initial decision persuasively rejected the basis for this argument: "Although [the senior manager] initialed the checklist, he did not cite any work papers evidencing the retrospective review, and Laccetti has not identified any work paper that actually purports to be the retrospective analysis required by AU § 316.64." What is at issue is not "recalculat[ing]" or "replicat[ing]" an analysis; the issue is, as the initial decision correctly framed it in discussing the violation, "confirm[ing] that a retrospective review had been performed, and review[ing] the results," under circumstances that magnified the procedure's importance. I.D. 77.

We conclude that the lack of the retrospective review was part of the reckless or, at a minimum, repeatedly negligent, course of conduct in which Laccetti engaged in assessing Taro USA's 2004 sales allowance estimates. Under the circumstances of this case, however, in which the clear gravamen of the conduct is addressed by the violations we have found and the sanctions we have imposed above, we do not impose additional sanctions for the AU § 316.64 violation. But, while not necessary to our determination of the sanctions we impose, this violation does reinforce the appropriateness of those sanctions.

IX.

As set forth above, we have found that the Division proved by a preponderance of the evidence that Laccetti violated PCAOB rules and auditing standards, and we have determined appropriate sanctions for those violations.

An appropriate order will issue. [47/]

By the Board (Board Member Ferguson
not participating)

[47/] We have considered all of the parties' contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

PCAOB
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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Mark E. Laccetti, CPA,

Respondent

PCAOB File No. 105-2009-007

ORDER IMPOSING SANCTIONS

January 26, 2015

On the basis of the Board's opinion issued this day it is

ORDERED that Mark E. Laccetti is barred from associating with any registered public accounting firm, provided that, after two (2) years, he may petition for Board consent to associate with a registered public accounting firm; and it is further

ORDERED that Mark E. Laccetti shall pay a civil money penalty in the amount of $85,000 by (a) United States postal money order, certified check, bank cashier's check or bank money order, (b) made payable to Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies the payer as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the

date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board (Board Member Ferguson not participating).

Phoebe W. Brown
Secretary

January 26, 2015

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Notice of Finality of Initial Decision

In the Matter of Hui Yi Chew,

Respondent.

PCAOB No. 105-2022-002

October 4, 2022

On August 10, 2022, the Chief Hearing Officer of the Public Company Accounting Oversight Board rendered the attached Initial Decision pursuant to PCAOB Rule 5204(b) ordering, as sanctions, that Respondent Hui Yi Chew ("Chew") be permanently barred from being an associated person of a registered public accounting firm and that Chew pay a civil money penalty in the amount of $100,000.

There having been no petition for Board review of the Initial Decision filed by any party pursuant to PCAOB Rule 5460(a) and no action by the Board to call the matter for review pursuant to PCAOB Rule 5460(b), the Initial Decision has today become final as to Chew pursuant to PCAOB Rule 5204(d).

Chew shall pay the civil money penalty by (a) wire transfer pursuant to instructions provided by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington D.C. 20006; and (e) submitted under a cover letter which identifies Chew as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Notice, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If Chew does not file an application for review by the Securities and Exchange Commission ("Commission") and the Commission does not order review of sanctions ordered against Chew on its own motion, the effective date of the sanctions shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Chew files an application for review by the Commission or the Commission orders review of sanctions ordered against Chew, the effective date of the sanctions ordered against Chew shall be the date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

Phoebe W. Brown
Secretary

October 4, 2022

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In the Matter of Hui Yi Chew,

Respondent.

PCAOB No. 105-2022-002

Hearing Officer – MBD

INITIAL DECISION (DEFAULT)

August 10, 2022

Summary

Respondent Hui Yi Chew ("Chew") was held in default pursuant to PCAOB Rule 5409(a) for failing to file an Answer in response to the Order Instituting Disciplinary Proceedings ("OIP"). Based upon the allegations of the OIP, which are deemed true and are also supported by evidence in the record, this Initial Decision finds that after learning of an upcoming inspection by the PCAOB's Division of Registration and Inspections, Chew improperly altered audit work papers that would be provided to the inspectors. Chew accordingly failed to cooperate with the PCAOB inspection and also violated PCAOB audit documentation requirements. When the PCAOB's Division of Enforcement and Investigations opened an investigation regarding her failure to cooperate with the PCAOB inspection, Chew failed to cooperate with the investigation. Pursuant to Section 105(b)(3) of the Sarbanes-Oxley Act of 2002, as amended, and PCAOB Rule 5300(b), this Initial Decision permanently bars Chew from association with any registered public accounting firm, and orders Chew to pay a civil monetary penalty of $100,000.

Appearances

Brett Collings, Esq., New York, NY, for the PCAOB's Division of Enforcement and Investigations.

No appearance by or on behalf of Respondent Hui Yi Chew.

INITIAL DECISION

I. PROCEDURAL BACKGROUND

On February 1, 2022, the Public Company Accounting Oversight Board ("PCAOB" or the "Board") issued an Order Instituting Disciplinary Proceedings ("OIP") setting forth allegations by the Division of Enforcement and Investigations ("Division") that, after learning of an upcoming inspection by the PCAOB's Division of Registration and Inspections ("DRI"), Respondent Hui Yi Chew ("Chew") improperly altered and directed the alteration of audit work papers that would be provided to the DRI inspectors. According to the Division's allegations, Chew violated the Sarbanes-Oxley Act of 2002, as amended (the "Act) and PCAOB rules and standards by violating PCAOB audit documentation requirements,[1] failing to cooperate with DRI's inspection, and, upon the initiation of an investigation by the Division into Chew's noncooperation with DRI's inspection, failing to cooperate with the Division's investigation.

The OIP directed that proceedings be held to determine whether the Division's allegations were true, to afford Chew an opportunity to establish any defenses to the allegations, and to determine what, if any, sanctions were appropriate against Chew for the

[1] The PCAOB's auditing documentation standard states in part that, "Prior to the report release date, the auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report. A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (*documentation completion date*) . . . . Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it." AS 1215.15-16, *Audit Documentation* (emphasis in original).

alleged violations. The OIP further directed Chew to file an Answer to the allegations contained in the OIP within twenty (20) days after service of the OIP.

On February 4, 2022, the Office of the Secretary of the PCAOB filed a Notice stating that the OIP was delivered to Chew on February 4, 2022, as evidenced by the FedEx delivery notification attached to the Notice. Accordingly, absent an extension, the deadline for Chew to file an Answer to the OIP was February 24, 2022. Chew failed to file an Answer to the OIP by the February 24 deadline.

On March 3, 2022, the Hearing Officer issued an order directing Chew to show cause by March 31, 2022, why she should not be deemed to be in default pursuant to PCAOB Rule 5409(a)(2) ("Show Cause Order"). The Show Cause Order advised Chew that if she failed to respond to the Show Cause Order within the time allowed (including a proposed Answer to the OIP), "Ms. Chew may be deemed to be in default, and a default decision may be issued finding that Ms. Chew committed the violations alleged in the OIP and imposing sanctions." The Show Cause Order was delivered to Chew by email and International FedEx.

Chew did not respond to the Show Cause Order. Accordingly, on April 11, 2022, the Hearing Officer issued an order deeming Chew to be in default pursuant to PCAOB Rule 5409(a)(2) (the "Default Order"). The Default Order noted that a copy of the Show Cause Order had been delivered to Chew on March 9, 2022, as evidenced by an International FedEx tracking document attached to the Default Order as an exhibit, and directed the Division to file a motion for issuance of a default decision with supporting materials by May 13, 2022, addressing Chew's violations and the appropriate sanctions for the violations. The Default Order was delivered to Chew by email and International FedEx.

On May 13, 2022, the Division filed a Motion for Issuance of a Default Decision ("Default Motion"), accompanied by a Statement of Undisputed Material Facts ("Div. Statement"), the Declaration of Brett Collings ("Collings Decl."), the Declaration of Thomas J. Barry ("Barry Decl."), and numerous supporting exhibits. The Default Motion requests that Chew be permanently barred from being associated with any registered public accounting firm, and that Chew be assessed a civil monetary penalty of $100,000. According to the Division's certificate of service, a copy of the Default Motion and supporting materials was served upon Chew by FedEx and electronic mail.

The Default Order provided a deadline of June 3, 2022, for Chew to file a response to the Division's Default Motion. To date, Chew has not filed any response to the Default Motion or otherwise participated in this proceeding.

II. FINDINGS OF FACT

The factual allegations in the OIP are deemed true pursuant to PCAOB Rule 5409(a). Additionally, a review of the evidentiary materials filed by the Division in support of its Default Motion supports a determination by a preponderance of the evidence that the OIP's factual allegations are true. *See* PCAOB Rule 5204(a).[2]

[2] When making findings, the Board should not rely solely on the allegations of the OIP, but should review the evidence submitted by its staff and determine whether the evidence adequately supports the findings requested. *See Paul Gaynes*, PCAOB File No. 105-2011-006 at 2 and 2 n.1 (Initial Decision Nov. 10, 2011; Notice of Finality Jan. 3, 2012). As the SEC noted in approving the imposition of sanctions by the NASD following a default in *James M. Russen, Jr.*, Exch. Act Rel. No. 32895, 51 S.E.C. 675, 678 n.12 (Sept. 14, 1993), "The [NASD] did not base its conclusion simply on the complaint's allegations; rather, it reviewed the record evidence presented by its staff and determined that the evidence supported a finding of violation. This approach affords this Commission a basis for discharging its review function under Section 19 of the Securities Exchange Act."

For the reasons set forth below, the Division's Default Motion is **GRANTED**.

A. Respondent

Chew is a member of the Institute of Singapore Chartered Accountants OIP ¶ 3; Div. Statement ¶ 7. Until October 2019, and at all relevant times, Chew was a senior associate at KPMG LLP (Singapore) ("KPMG Singapore" or the "Firm"). *Id.* At all relevant times, Chew was an associated person of a registered public accounting firm as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i). OIP ¶ 3; Barry Decl. ¶ 6, Ex. 6; Barry Decl. ¶ 7, Ex. 7; Barry Decl. ¶ 9, Ex. 9; Div. Statement ¶ 7.

Chew was employed by KPMG Singapore until the Firm placed Chew on administrative leave on August 30, 2019. Barry Decl. ¶ 9, Ex. 9; Div. Statement ¶ 33. On September 30, 2019, Chew provided the Firm with notice of her resignation, effective as of October 29, 2019. *Id*.

B. Other Relevant Entities and Individual

KPMG Singapore is a limited liability partnership organized under Singapore law and headquartered in Singapore and is a member of the KPMG International network of firms. At all relevant times KPMG Singapore was a registered public accounting firm as that term is defined in PCAOB Rule 1001(r)(i). OIP ¶ 4; Barry Decl. ¶ 1, Ex. 1; Barry Decl. ¶ 2, Ex. 2; Div. Statement ¶ 1.

KPMG Wirtschaftsprüfungsgesellschaft ("KPMG Germany") is also a member of the KPMG International network of firms and is headquartered in Berlin, Germany. At all relevant times KPMG Germany was a registered public accounting firm as that term is defined in PCAOB Rule 1001(r)(i). Barry Decl. ¶ 3, Ex. 3; Barry Decl. ¶ 4, Ex. 4; Div. Statement ¶ 2.

Issuer A is a software company based in Germany with American Depository Shares listed on the New York Stock Exchange. At all relevant times, Issuer A was an issuer as that term is defined by PCAOB Rule 1001(i)(iii) and Section 2(a)(7) of the Act. OIP ¶ 6; Barry Decl. ¶ 4, Ex. 4. Issuer A's Asian subsidiary is based in Singapore. *Id*.; Barry Decl. ¶ 5, Ex. 5; Div. Statement ¶ 3. Chew was a member of the engagement team that conducted the Firm's audit of the 2018 financial statements of Issuer A's Asian subsidiary ("Subsidiary Audit"). OIP ¶ 3; Div. Statement ¶ 7.

Tan Joon Wei ("Tan") is a member of the Institute of Singapore Chartered Accountants. Until January 2020, and at all relevant times, Tan was a manager at KPMG Singapore and a member of the Subsidiary Audit engagement team.[3] Tan was terminated by the Firm on January 29, 2020. Barry Decl. ¶ 9, Ex. 9; Div. Statement ¶ 8. On March 29, 2021, the Board issued an order, to which Tan consented without admitting or denying the substantive allegations, sanctioning Tan and imposing a two-year associational bar with the right to petition for termination of his bar after two years for noncooperation with DRI's 2019 inspection of KPMG Singapore. *See Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions In the Matter of Tan Joon Wei*, PCAOB Rel. No. 105-2021-001 (Mar. 29, 2021). OIP ¶ 5; Div. Statement ¶ 8.

[3] Tan is also referred to as "Winn Tan." *See* Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41; Div. Statement ¶ 12 n.2.

C. In Anticipation of a PCAOB Inspection, Chew Improperly Altered and Directed the Alteration of Work Papers Following the Documentation Completion Date

1. DRI's Notification of a Planned Inspection of KPMG Singapore

KPMG Singapore performed referred work in support of the audit opinion on Issuer A's year-end 2018 financial statements issued by KPMG Germany on February 20, 2019, including certain financial information of Issuer A's Asian subsidiary. Div. Statement ¶ 4. The documentation completion date for Issuer A's audit was April 6, 2019. KPMG Singapore assembled for retention the final sets of electronic and hard copy work papers for the Subsidiary Audit on March 5, 2019, and April 6, 2019, respectively. OIP ¶ 11; Barry Decl. ¶ 8, Ex. 8; Div. Statement ¶ 5. The Subsidiary Audit engagement team archived the electronic work papers for the Subsidiary Audit on March 5, 2019, and archived the hard copy work papers for the Subsidiary Audit on April 6, 2019. Barry Decl. ¶ 8, Ex. 8; Barry Decl. ¶ 9, Ex. 9; Div. Statement ¶ 6.

By letter dated July 16, 2019, DRI notified KPMG Singapore that the Firm had been selected for inspection, with fieldwork scheduled to begin on August 19, 2019. Chew learned of the scheduled inspection and, in early August, of the inspectors' selection of the Subsidiary Audit for review as part of that inspection. OIP ¶ 12; Div. Statement ¶ 9; Barry Decl. ¶ 10, Ex. 10.

2. Chew's Reaction to DRI's Selection of the Subsidiary Audit for Inspection

On August 4, 2019, Tan informed Chew through a WhatsApp chat that DRI had selected the Subsidiary Audit for review stating, "Boss I think [Issuer A] got picked for pcaob . . . We are screwed." Barry Decl. ¶ 12, Ex. 12; Div. Statement ¶ 11. Chew responded, "omg deadddd . . . I can’t even save myself.” When told by Tan that DRI was supposed to pick focus areas for the inspection, including potentially controls, Chew responded, “If controls we die . . . FSA we also die . . . This is a scary ending.” *Id*.

In an August 5, 2019, online chat, Chew informed Charmaine Tang, another senior associate at KPMG Singapore who worked on the Subsidiary Audit, that “winn say [Issuer A] selected for pcaob [a]sia . . . i think the pcaob more shit . . . they check the whole au[d]it . . . and will ask why we do this this this . . . why nev[e]r do that that that . . . is death.” Barry Decl. ¶ 13, Ex. 13; Div. Statement ¶ 12.

In another August 5, 2019, online chat, senior associate Harriet Phang, who also worked on the Subsidiary Audit, wrote to Chew, “winn just told me.” Barry Decl. ¶ 14, Ex. 14; Div. Statement ¶ 13. After they discussed Tan’s reaction to the selection of the Subsidiary Audit for review, Chew wrote to Phang, “everything is die . . . omgggg.” *Id*. Later in the same chat, Phang wrote to Chew, “Maybe winn th[i]nks we followed the standards? . . . HAHAH,” to which Chew responded, “dieeee.” After Phang sent Chew a question Tan asked regarding alternative procedures for confirmations, Chew responded, “i think never doc the details . . . need to dig out the invoices if want all the details.” *Id*.

3. Chew Altered and Directed the Alteration of Work Papers After the Audit Documentation Completion Date

Between August 7, 2019, and the beginning of inspection fieldwork on August 19, 2019, Chew worked with other Firm audit staff to modify four work papers from the Subsidiary Audit—a software revenue sampling work paper, two work papers related to alternative procedures for confirmations, and a cloud revenue work paper. Chew directed junior audit staff to modify certain of those work papers and also edited electronic versions of certain of those work papers herself. Chew also instructed that modified versions of the work papers be placed in the hard copy work paper binders for the Subsidiary Audit. OIP ¶ 16; Div. Statement ¶¶ 16-22.

In an August 7, 2019, online chat, Chew wrote to Tan, "we have all the invoices, just that all along like we never rly doc the details of the invoices that kind . . . will it be possible to plot a [junior audit staff] tmr to doc down the details?" Barry Decl. ¶ 15, Ex. 15; Div. Statement ¶ 14. Tan responded, "hahahaha we cannot be doing work now." *Id*.; OIP ¶ 15. Later in the same chat, Chew wrote, "we do hardcopy and file in? . . . then no timestamp." Tan responded, "ya lor."[4] Chew also suggested to Tan that they could "try to get some time to document the alternative." *Id*. Tan responded affirmatively, and later on August 7, 2019, at Tan's instruction, a junior audit staff member, Gabriel Lim ("Lim"), and Phang checked the hard copy work paper files for the Subsidiary Audit out of KPMG Singapore's Central Filing Room. Barry Decl. ¶ 9, Ex. 9; Barry Decl. ¶ 16, Ex. 16; Div. Statement ¶¶ 14-15.

Over the course of the following week, Chew then altered — or directed Lim to alter — four work papers for the Subsidiary Audit. The alterations Chew made and oversaw to the work papers included deletions and additions made to the content of the work papers. The altered work papers contained no indication they had been modified following the April 6, 2019, documentation completion date for the Issuer A audit and the Subsidiary Audit, nor any information concerning who made the modifications or when or why they had been made. OIP

[4] "Ya lor" is a Singapore English colloquialism indicating affirmation or acceptance. Div. Statement ¶ 14 n.3.

¶¶ 11, 17-18; Barry Decl. ¶ 8, Ex. 8; Div. Statement ¶¶ 5, 16-28.

(a) Software Revenue Sampling Plan

On August 7, 2019, Chew sent Lim two emails, one of which with the subject "to print tmr tgt with software revenue memo and ksp," and both of which attached a copy of a Software Revenue Sampling Plan work paper for the Subsidiary Audit ("Sampling Plan Work Paper"). Barry Decl. ¶ 25, Ex. 25; Barry Decl. ¶ 27, Ex. 27; Div. Statement ¶ 20. The copies of the Sampling Plan Work Paper attached to Chew's emails differed from each other, and from the version saved in the archived electronic work papers for the Subsidiary Audit. *Compare* Barry Decl. ¶ 25, Ex. 25 and Barry Decl. ¶ 27, Ex. 27 *with* Barry Decl. ¶ 26, Ex. 26; Div. Statement ¶ 21. The version of the Sampling Plan Work Paper attached to one of Chew's emails was the version added to the hard copy work paper files for the Subsidiary Audit. *Compare* Barry Decl. ¶ 27, Ex. 27 *with* Barry Decl. ¶ 28, Ex. 28; *see also* Barry Decl. ¶ 21, Ex. 21; Div. Statement ¶ 21. In that version of the Sampling Plan Work Paper, certain inputs to the sampling calculation, including the monetary values and amounts of certain items were updated; the original version of the Sampling Plan Work Paper used values from the third quarter of 2018, and the revised version updated those values as of year-end 2018. *Compare* Barry Decl. ¶ 26, Ex. 26 *with* Barry Decl. ¶ 28, Ex. 28; Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 2 (Response 19.c); Barry Decl. ¶ 9, Ex. 9; Div. Statement ¶ 21. Chew made the modifications to the Sampling Plan Work Paper herself. Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 2 (Response 19.a); Div. Statement ¶ 21.

Lim printed the revised copy of the Sampling Plan Work Paper on August 8, 2019. Barry Decl. ¶ 24, Ex. 24, at 499 (Transaction IDs 26499130-133). After Lim printed the revised copy of the Sampling Plan Work Paper, Chew added it to the hard copy work paper binders for the Subsidiary Audit. Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 2 (Response 19.m); Div. Statement ¶ 22.

(b) Quarterly Confirmations Alternative Procedures and Singapore Confirmations Alternative Procedures

On August 7, 2019, Chew and Lim engaged in an online chat in which Chew provided instruction to Lim on where to locate certain confirmations related to the Subsidiary Audit and informed him that Tan was "ok with just vouching invoices for our alternative . . . so can just print it out when youre done." Barry Decl. ¶ 17, Ex. 17; Div. Statement ¶ 16. Chew also instructed Lim to "amend the GW 3.0020 wp and send me too," and subsequently specified that she wanted Lim to "add a column behind also . . . 'invoice ties to contract amount?' . . . then you put Y with tax of x% . . . something like the quarterly one." *Id*.

On the afternoon of August 7, 2019, Lim emailed Chew a copy of "GW3.0020 Software Rev Contract Summary (edited)" ("Singapore Confirmations Alternative Procedures Work Paper"), which he had updated at Chew's request. Barry Decl. ¶ 18, Ex. 18; Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 3 (Response 23.b); Div. Statement ¶ 17. The copy of the Singapore Confirmations Alternative Procedures Work Paper attached to Lim's email differed from the version saved in the archived electronic work papers for the Subsidiary Audit. Barry Decl. ¶ 9, Ex. 9; *compare* Barry Decl. ¶ 19, Ex. 19 *with* Barry Decl. ¶ 20, Ex. 20; *see also* Barry Decl. ¶ 21, Ex. 21; Div. Statement ¶ 17. The revised version omitted one contract previously included, and contained two new contracts not previously included, in the sample population. Barry Decl. ¶ 9, Ex. 9; *compare* Barry Decl. ¶ 19, Ex. 19 *with* Barry Decl. ¶ 20, Ex. 20; Barry Decl.

¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 3 (Response 23.d); Div. Statement ¶ 17. The revised version also contained new columns that listed details of vouched invoices, including a column with the header "Invoice Ties to Contract Amount" within which certain cells included the entry "Y, with tax of 7%." *Compare* Barry Decl. ¶ 19, Ex. 19 *with* Barry Decl. ¶ 20, Ex. 20; *see also* Barry Decl. ¶ 21, Ex. 21; Div. Statement ¶ 17.

Lim's August 7, 2019, email attaching the revised Singapore Confirmations Alternative Procedures Work Paper also attached a spreadsheet named "Copy of FY18 External and Internal Confirmations Checklist Q1-Q4 050419" ("Quarterly Confirmations Alternative Procedures Work Paper"). Barry Decl. ¶ 18, Ex. 18; Div. Statement ¶ 18. That version of the Quarterly Confirmations Alternative Procedures Work Paper differed from the version saved in the archived electronic work papers for the Subsidiary Audit. Barry Decl. ¶ 9, Ex. 9; *compare* Barry Decl. ¶ 22, Ex. 22 *with* Barry Decl. ¶ 23, Ex. 23; *see also* Barry Decl. ¶ 21, Ex. 21; Div. Statement ¶ 18. The revised version of the Quarterly Confirmations Alternative Procedures Work Paper contained additional columns documenting information related to external confirmations the Firm received in connection with the Subsidiary Audit (including some received by the Firm after the documentation completion date), as well as information related to internal sales representations made by Issuer A's Asian subsidiary. *Compare* Barry Decl. ¶ 22, Ex. 22 *with* Barry Decl. ¶ 23, Ex. 23; *see also* Barry Decl. ¶ 21, Ex. 21; Barry Decl. ¶ 9, Ex. 9; Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41 at 2 (Response 21.c); Div. Statement ¶ 18; OIP ¶ 18.b.

Lim printed revised copies of the Singapore Confirmations Alternative Procedures Work Paper and the Quarterly Confirmations Alternative Procedures Work Paper on August 8, 2019. Barry Decl. ¶ 24, Ex. 24, at 486-487 (Transaction IDs 26498092-093, 26498182); Div. Statement

¶ 19.

(c) Cloud Revenue – Test of Details

In a July 24, 2019, WhatsApp conversation, Tan wrote to Chew, "I realised we didn't test capitalise contract costs and it's not covered by group :/" and asked Chew to "help me pull!" Barry Decl. ¶ 12, Ex. 12, at 8; Div. Statement ¶ 23. On July 26, 2019, Tan emailed Melinda Foo at Issuer A's Asian subsidiary, beginning a series of email communications between Tan and Foo in which Tan requested information about Issuer A's Asian subsidiary's cloud customers. Barry Decl. ¶ 29, Ex. 29; Div. Statement ¶ 23.

On August 6, 2019, Chew emailed Tan (copying Phang) regarding a "Cloud Revenue Summary – to discuss with Melinda" and then sent Tan (again copying Phang) an email stating, "Updated!" that attached a copy of the Cloud Revenue Review Work Paper for the Subsidiary Audit ("Cloud Revenue Work Paper"). Barry Decl. ¶ 30, Ex. 30; Div. Statement ¶ 24.

In an August 8, 2019, online chat with Tang, Chew wrote, "sigh [Issuer A] is screwed" and when Tang asked why, Chew responded "the pcaob inspection . . . I think our revenue also not there . . . especially the cloud one." Barry Decl. ¶ 31, Ex. 31; Div. Statement ¶ 25.

On August 13, 2019, Chew emailed Phang another copy of the Cloud Revenue Work Paper, which Chew had revised and which therefore differed from the version of the same work paper in the archived electronic audit file for the Subsidiary Audit. Barry Decl. ¶ 32, Ex. 32; Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 3 (Responses 24, 25.a); *compare* Barry Decl. ¶ 33, Ex. 33 *with* Barry Decl. ¶ 34, Ex. 34; Barry Decl. ¶ 21, Ex. 21; Div. Statement ¶ 26. Specifically, the altered version of the Cloud Revenue Work Paper contained revised inputs and additional information regarding the timing of certain cloud licenses, annual fees, and revenues. Barry Decl. ¶ 9, Ex. 9; *compare* Barry Decl. ¶ 33, Ex. 33 *with* Barry Decl. ¶ 34, Ex. 34; *see also* Barry Decl. ¶ 21, Ex. 21; OIP ¶ 18.d; Div. Statement ¶ 26. In her email, Chew asked Phang to "help me print this and file into the cloud file in my locker." Barry Decl. ¶ 32, Ex. 32. Phang then forwarded Chew's email to Lim and wrote, "Please print! I will pass you the file." Barry Decl. ¶ 35, Ex. 35; Div. Statement ¶ 26.

Lim printed the revised copy of the Cloud Revenue Work Paper on August 13, 2019. Barry Decl. ¶ 24, Ex. 24, at 570 (Transaction IDs 26504110-112); Div. Statement ¶ 27; OIP ¶ 18.d.

Chew added the revised copies of the four work papers—the Singapore Confirmations Alternative Procedures Work Paper, the Quarterly Confirmations Alternative Procedures Work Paper, the Sampling Plan Work Paper, and the Cloud Revenue Work Paper—to the hard copy binders for the Subsidiary Audit prior to the beginning of inspection fieldwork. Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 2-4 (Responses 19.m, 21.n, 23.n, 25.n); Div. Statement ¶ 28. Chew was aware that the binders containing the four modified work papers would be provided to the DRI inspectors when they conducted their fieldwork. Barry Decl. ¶ 38, Ex. 38; Barry Decl. ¶ 41, Ex. 41, at 2-4 (Responses 19.l, 21.m, 23.m, 25.m); Div. Statement ¶ 28. None of the altered work papers indicated that they had been added to the binders after the documentation completion date for that audit or that their content had been modified after the documentation completion date for that audit, by whom those alterations had been made, nor the reasons for the alterations. Barry Decl. ¶ 20, Ex. 20; Barry Decl. ¶ 23, Ex. 23; Barry Decl. ¶ 28, Ex. 28; Barry Decl. ¶ 34, Ex. 34; Div. Statement ¶ 28.

On August 16, 2019, after the last of the four modified work papers had been printed and added to the hard copy work paper binders, Chew notified Tan through an online chat that "we reprinted the hardcopy," to which Tan replied, "based on the latest number . . . I damn scared they go and catch the hardcopy." Div. Statement ¶ 29; Barry Decl. ¶ 36, Ex. 36; OIP ¶ 20; Div. Statement ¶ 28.

D. DRI's Inspection and KPMG Singapore's Internal Investigation

DRI's fieldwork for the 2019 inspection of KPMG Singapore began on August 19, 2019. Barry Decl. ¶ 10, Ex. 10. The Firm made available to the DRI inspectors the archived work papers, both electronic and hard copy, on that date. Div. Statement ¶ 30. During the course of their fieldwork, DRI staff noticed that certain work papers in the hard copy files resembled—but differed from—corresponding work papers in the electronic audit file for the Subsidiary Audit. Collings Decl. ¶ 2; Barry Decl. ¶ 9, Ex. 9; OIP ¶ 22; Div. Statement ¶ 31. The DRI inspectors questioned those discrepancies and following DRI's inquiry, KPMG Singapore conducted an internal investigation, which identified the versions of the Singapore Confirmations Alternative Procedures Work Paper, the Quarterly Confirmations Alternative Procedures Work Paper, the Sampling Plan Work Paper, and the Cloud Revenue Work Paper included in the Subsidiary Audit's hard copy work paper binders as having been modified following the documentation completion date for that audit and in advance of DRI's inspection. Barry Decl. ¶ 9, Ex. 9; Barry Decl. ¶ 21, Ex. 21; Div. Statement ¶¶ 31, 32.

As part of KPMG Singapore's internal investigation, senior Firm personnel questioned Chew. Chew falsely claimed that any revisions to work papers from the Subsidiary Audit were made because she and others were using the Subsidiary Audit file as a "live file" that also supported the then ongoing statutory audit of Issuer A's Asian subsidiary and for the purpose of enhancing the procedures and documentation for the local statutory audit and not the Subsidiary Audit. Barry Decl. ¶ 37, Ex. 37; OIP ¶ 23; Div. Statement ¶ 32. In fact, the email correspondence and text messages exchanged among Chew and other KPMG Singapore personnel in August 2019 relating to the need to make alterations to the work papers before an imminent PCAOB inspection demonstrate that the revisions to the work papers had nothing to do with a statutory audit. This Initial Decision concludes that the audit work papers were modified as part of a deliberate attempt to deceive the DRI inspectors.

KPMG Singapore placed Chew on administrative leave on August 30, 2019. Barry Decl. ¶ 9, Ex. 9. On September 30, 2019, Chew provided the Firm with notice of her resignation, effective as of October 29, 2019. *Id*.; Div. Statement ¶ 33.

E. The Division's Investigation

Following DRI's 2019 inspection of KPMG Singapore, on September 10, 2019, the Division opened an informal inquiry to investigate potential noncooperation by the Firm. Collings Decl. ¶ 2; Div. Statement ¶ 34. As part of that inquiry, the Division issued a request for information to Chew concerning her involvement in the Subsidiary Audit and her preparation for and activities in connection with DRI's review of that engagement. Barry Decl. ¶ 38, Ex. 38; Div. Statement ¶ 35. The Division transmitted the request to Chew on April 9, 2020, via email, to a personal email address that KPMG Singapore provided to the Division (Chew's "Personal Email Address"). Barry Decl. ¶ 40, Ex. 40; *see also* Barry Decl. ¶ 9, Ex. 9; Barry Decl. ¶ 39, Ex. 39; OIP ¶ 27; Div. Statement ¶ 35.

On April 30, 2020, Chew submitted her responses to the Division's request for information by email from her Personal Email Address. Barry Decl. ¶ 41, Ex. 41; OIP ¶ 27; Div.

Statement ¶ 36. Chew's responses included representations that "the workpapers were updated for the purpose of the local statutory work done, and these were documented in our hardcopy files. When Winn Tan reviewed the file in May 2019, updates were subsequently performed from May 2019 onwards to ensure that the work done for our local statutory FS was complete and accurate. These files were subsequently submitted for the PCAOB review." Barry Decl. ¶ 41, Ex. 41 at 2 (Response 16). This explanation by Chew is contradicted by the documentary evidence that Chew made revisions and directed others to make revisions to the work papers to conceal deficiencies in the Subsidiary Audit.

On October 30, 2020, a telephone conference call was held between the Division and Chew during which Division staff summarized their initial conclusions regarding their investigation and discussed a potential settlement with Chew. Div. Statement ¶ 38. Both before and following the October 30, 2020, telephone call, Division staff communicated with Chew using Chew's Personal Email Address. Collings Decl. ¶ 4. Following the October 30, 2020, telephone call, Chew communicated with Division staff using her Personal Email Address to ask questions about the possible settlement. *Id.* However, Chew did not respond to two emails that Division staff sent to Chew's Personal Email Address in January 2021 regarding potential settlement. *Id.* ¶ 5.

F. The Division's Accounting Board Demands to Chew and Chew's Failure to Respond

On March 29, 2021, the Board issued an Order of Formal Investigation ("OFI") related to potential violations of PCAOB rules and auditing standards in connection with the Subsidiary Audit and DRI's inspection of it. Barry Decl. ¶ 52, Ex. 52; OIP ¶ 31; Div. Statement ¶ 45.

Pursuant to that OFI, the Division prepared an Accounting Board Demand ("ABD") requiring Chew to provide certain documents and information by May 4, 2021, and transmitted it to Chew on April 20, 2021 ("April ABD"). Barry Decl. ¶ 53, Ex. 53; OIP ¶ 32. The April ABD included language explaining that "FAILURE TO COMPLY WITH THIS DEMAND MAY SUBJECT YOU TO SANCTIONS UNDER SECTION 105(b)(3) OF THE SARBANES-OXLEY ACT OF 2002, as amended (15 U.S.C. § 7215(b)(3)(A)), AND PCAOB RULE 5300(b)." Barry Decl. ¶ 53, Ex. 53; OIP ¶ 33; Div. Statement ¶ 46. Division staff enclosed with the April ABD a copy of PCAOB Form ENF-1 ("ENF-1"), which also describes the consequences of failing to comply with an ABD or otherwise failing to cooperate with an investigation. Barry Decl. ¶ 53, Ex. 53; OIP ¶ 36; Div. Statement ¶ 46.

The Division served the April ABD on Chew by emailing it to her Personal Email Address. Barry Decl. ¶ 54, Ex. 54; Div. Statement ¶ 47. The Division's transmittal email informed Chew that the Board had instituted a formal investigation and that her failure to comply with an ABD would constitute noncooperation under PCAOB Rule 5110 and be grounds for disciplinary action. *Id*. at 1; OIP ¶ 34. The Division's transmittal email again offered to discuss potential settlement with Chew, if she was interested. Div. Statement ¶ 47.

The Division also served Chew with a copy of the April ABD by sending it, via FedEx, to a residential address for Chew that KPMG Singapore provided to the Division during its investigation ("Chew's Residential Address"). Barry Decl. ¶ 9, Ex. 9; OIP ¶ 35; Div. Statement ¶ 48. FedEx confirmed that the package containing the April ABD was delivered and signed for on April 26, 2021. Barry Decl. ¶ 55, Ex. 55; OIP ¶ 35; Div. Statement ¶ 48.

After Chew failed to respond to the April ABD by the May 4, 2021 deadline specified therein, the Division sent Chew a follow-up letter dated May 14, 2021, which enclosed another copy of the April ABD and ENF-1, and which offered to extend the deadline for Chew's response to May 21, 2021. Barry Decl. ¶ 56, Ex. 56; OIP ¶ 37; Div. Statement ¶ 49. The Division's letter reminded Chew that "failure to comply with an ABD may subject you to sanctions under Section 105(b)(3)(A) of the Sarbanes-Oxley Act of 2002, as amended (15 U.S.C § 7215(b)(3)(A)), and PCAOB Rule 5300(b)." Barry Decl. ¶ 56, Ex. 56; OIP ¶ 37; Div. Statement ¶ 49.

The Division transmitted its May 14, 2021, letter to Chew by sending it to her Personal Email Address and also sending an additional copy via FedEx to Chew's Residential Address. Barry Decl. ¶ 56, Ex. 56; OIP ¶ 38. FedEx confirmed that the Division's letter was delivered and signed for on May 22, 2021. Barry Decl. ¶ 57, Ex. 57; OIP ¶ 38. Chew did not respond in any way to the April ABD. Collings Decl. ¶ 6; OIP ¶ 39; Div. Statement ¶ 50.

On May 26, 2021, the Division issued an ABD to Chew ("May ABD") requiring Chew to appear via videoconference for sworn testimony on June 14, 2021. Barry Decl. ¶ 58, Ex. 58; OIP ¶ 40; Div. Statement ¶ 51. The Division's transmittal letter enclosing the May ABD requested that Chew contact the Division by June 2, 2021, to confirm her availability for testimony at the designated time or to arrange a mutually convenient alternative time. Barry Decl. ¶ 58, Ex. 58, at 2; OIP ¶ 42; Div. Statement ¶ 51. The transmittal letter also provided instructions about the videoconference platform that would be used for Chew's testimony and provided a toll-free international number that would be used for the audioconference of her testimony. Barry Decl. ¶ 58, Ex. 58, at 2; OIP ¶ 43; Div. Statement ¶ 51. In its letter, the Division again informed Chew that failure to comply with an ABD could subject her to sanctions pursuant to Section

105(b)(3)(A) of the Act and PCAOB Rule 5300(b) and enclosed another copy of ENF-1. Barry Decl. ¶ 58, Ex. 58, at 2, 22-24; OIP ¶ 42; Div. Statement ¶ 51.

The Division served the May ABD on Chew by emailing it to her Personal Email Address. Barry Decl. ¶ 58, Ex. 58, at 1; OIP ¶ 41; Div. Statement ¶ 52. The Division's transmittal email reiterated the instruction from its cover letter that Chew confirm with the Division, by June 2, 2021, that she could attend her testimony on June 14, 2021, or request an alternate time. Barry Decl. ¶ 58, Ex. 58, at 1; Div. Statement ¶ 52. The Division also served a copy of the May ABD on Chew via FedEx, which confirmed that the May ABD was delivered to Chew's Residential Address and signed for on May 31, 2021. Barry Decl. ¶ 59, Ex. 59; Div. Statement ¶ 52.

The Division confirmed that two emails sent to Chew's Personal Email Address with instructions regarding her testimony were received on May 27, 2021, but Chew failed to respond to the Division to either confirm her availability on June 14, 2021, or request an alternative date for her testimony. Collings Decl. ¶¶ 7, 9; Div. Statement ¶¶ 53-54.

The Division sent a follow-up email to Chew's Personal Email Address on June 8, 2021, explaining that Chew's testimony remained scheduled for June 14, 2021, and asking her to confirm that she would attend. Barry Decl. ¶ 60, Ex. 60, at 1; OIP ¶ 46. The Division's email attached another copy of the May ABD. Barry Decl. ¶ 60, Ex. 60; Div. Statement ¶ 55.

Chew did not respond to the Division's June 8, 2021, correspondence regarding the May ABD and the testimony scheduled for June 14, 2021. Collings Decl. ¶ 9; OIP ¶ 47; Div. Statement ¶ 56.

At the time scheduled for Chew's testimony on June 14, 2021, Division staff and a court reporter logged into the videoconference platform and dialed into the audioconference number for Chew's testimony, but Chew did not appear. The Division sent an email to Chew's Personal Email Address reminding her that her testimony had begun and asking whether she was having technical difficulties connecting to the videoconference platform. Despite repeated efforts by the Division to contact Chew, an hour after the scheduled start of Chew's testimony, she still had not logged into the videoconference platform, joined the audioconference by dialing in, or contacted the Division. Collings Decl. ¶¶ 10-11; OIP ¶ 48; Barry Decl. ¶ 61, Ex. 61, at 1; Div. Statement ¶ 57.

When Chew did not appear for her scheduled testimony on June 14, 2021, Division staff made a statement on the record referencing the Division's various attempts to contact Chew regarding her testimony and her failure to appear, and terminated the testimony. Collings Decl. ¶ 11; Barry Decl. ¶ 62, Ex. 62; OIP ¶ 49; Div. Statement ¶ 58.

All of the Division's email communications to Chew were sent to her Personal Email Address. After initially corresponding with the Division using her Personal Email Address on a number of occasions, Chew never indicated to the Division that it should cease using that email address to contact her, or that the Division should address correspondence to Chew to a different email (or physical) address. Collings Decl. ¶ 13. None of the Division's emails to Chew's Personal Email Address were ever returned as undeliverable. *Id*. ¶ 12; Div. Statement ¶ 59.

III. CHEW VIOLATED THE ACT AND PCAOB RULES AND STANDARDS

The evidence submitted by the Division in support of the Default Motion establishes that Chew failed to cooperate with a Board inspection. PCAOB Rule 4006, *Duty to Cooperate with Inspectors*, requires that "every associated person of a registered public accounting firm, shall cooperate with the Board in the performance of any Board inspection." Cooperation under this rule includes an obligation not to provide improperly altered documents or misleading information in connection with the Board's inspection processes. *See, e.g., Kabani & Co., Inc.*, Rel. No. 34-80201, 2017 WL 947229, at *12 (SEC Mar. 10, 2017) ("Implicit in [Rule 4006's] cooperation requirement is that auditors provide accurate and truthful information."), *petition for review denied, Kabani & Co., Inc. v. SEC,* 733 F. App'x 918 (9th Cir. 2018); *Ryan J. Collins, CPA*, PCAOB Rel. No. 105-2020-009 (July 21, 2020) (sanctioning senior manager who made misleading statements to, and prepared a misleading document provided to, DRI inspectors); *Hyun Seung Lee*, PCAOB Rel. No. 105-2019-027 (Oct. 31, 2019) (sanctioning partner who backdated work papers, and was aware of the improper alteration of other work papers, in advance of a DRI inspection); *Seul Hyang Wee*, PCAOB Release No. 105-2019-026 (Oct. 31, 2019) (same).

An auditor provides misleading information if he or she fails to disclose that documentation presented to inspectors as having existed at the time of the audit was, in fact, subsequently altered or created after the documentation completion date. *See, e.g., Humayoun G. Khan*, PCAOB Rel. No. 105-2019-013 (June 4, 2019) (respondent violated PCAOB Rule 4006 because he improperly altered an archived work paper in advance of a DRI inspection and provided a copy of the altered work paper to inspectors without disclosing the alterations); *Elliot D. Kim, CPA*, PCAOB Rel. No. 105-2018-010 (May 23, 2018) (respondent violated PCAOB Rule 4006 when he remained silent during discussion with DRI inspectors of a document that he had improperly altered); *José Fernando Alves*, PCAOB Rel. No. 105-2016-039 (Dec. 5, 2016) (respondent violated PCAOB Rule 4006 when he failed to disclose during a meeting with DRI inspectors that he had learned that certain documents had been improperly altered); *Renata*

Coelho de Sousa Castelli, PCAOB Rel. No. 105-2016-040 (Dec. 5, 2016) (same).

PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards,* requires that associated persons of a registered firm "shall comply with all applicable auditing and related professional practice standards." PCAOB Rule 3200, *Auditing Standards*, similarly requires that "[i]n connection with the preparation or issuance of any audit report, a registered public accounting firm and its associated persons shall comply with all applicable auditing standards adopted by the Board and approved by the SEC." In turn, the PCAOB's audit documentation standard require that audit documentation "must not be deleted or discarded after the documentation completion date," and that any information added to audit documentation after the documentation completion date "must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it." AS 1215.15-16.

Chew violated PCAOB Rules 3100 and 3200, as well as AS 1215. After learning that the Subsidiary Audit had been selected for review by DRI, Chew repeatedly expressed concern to colleagues about the quality of the work conducted during that audit. Chew then proposed, and directly participated in, a plan to improperly alter certain Subsidiary Audit work papers and add them to the hard copy work paper binders. That course of conduct enabled Chew not only to modify the work papers but also to conceal the modifications by employing a method that did not leave behind any "timestamp" or other metadata evidence.

Chew's modification of workpapers after the documentation completion date in anticipation of a Board inspection, with a clear intent to remedy what Chew believed was deficient audit work in order to mislead DRI's inspectors, violated PCAOB Rule 4006. *See, e.g.,* *Stan Jeong-Ha Lee*, PCAOB File No. 105-2012-001, at 15 ("the falsification of audit documentation to mislead PCAOB inspectors as to the work performed by the firm being inspected is the antithesis of cooperation").

The evidence also clearly establishes that by failing to respond to two ABDs, Chew failed to cooperate with a Board investigation as required by the Act and the PCAOB's rules.

IV. SANCTIONS

As sanctions for Chew's misconduct, the Division requests that Chew be permanently barred from association with any registered public accounting firm, and that Chew be ordered to pay a civil money penalty of $100,000.

A. Permanent Bar

A failure to cooperate with a Board investigation is serious misconduct warranting strong sanctions. *See* PCAOB Rule 5300(b)(1). Additionally, Chew's violations of PCAOB rules and auditing standards in connection with DRI's inspection of KPMG Singapore, as discussed above, were clearly intentional or knowing. This Initial Decision accordingly finds that Chew's conduct meets the conditions set out in Section 105(c)(5) of the Act, which provides that a temporary or permanent suspension or bar of any person from further association with any registered public accounting firm may only be imposed in the event of intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable statutory, regulatory, or professional standard, or repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

The PCAOB determines appropriate sanctions by considering "the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, to carry out [the Board's] statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate and independent issuer audit reports." *See In the Matter of Melissa K. Koeppel, CPA*, PCAOB File No. 105-2011-007, at 177 (Dec. 29, 2017); *S. Brent Farhang, CPA*, PCAOB File No. 105-2016-001, at 21 (Mar. 16, 2017), *aff'd*, SEC Exch. Act Rel. No. 83494 (June 21, 2018). One of the aggravating factors the PCAOB considers in determining sanctions is a respondent's disregard for the Board's processes. *See Farhang*, PCAOB File No. 105-206-001, at 9. The "inquiry into the appropriate remedial sanction is a flexible one, and no one factor is dispositive." *Cordovano* at 50 (quoting *Chris G. Gunderson*, Exch. Act Rel. No. 61234, 2009 SEC LEXIS 4322, at *20 (Dec. 23, 2009))."

Numerous aggravating factors weigh in favor of significant sanctions for Chew, and no mitigating factors appear to be present. Chew knew that she could not alter work papers after the documentation completion date and in advance of a Board inspection, but nonetheless devised a plan that she believed would allow her to do so without getting caught because altered hard copy work papers had "no timestamp." Chew's goal in altering the work papers was to mislead DRI's inspectors by correcting what she believed were deficiencies in audit work. When asked about the work paper modifications, Chew gave Firm personnel an implausible excuse contradicted by the facts, which she later repeated to the Division in an April 30, 2020, email. And, after initially engaging with the Division during its inquiry, Chew failed to cooperate with the Division's investigation, despite being repeatedly warned about her obligation to respond to the April ABD and the May ABD. Chew's conduct reflects her intent to impede a Board inspection by misleading DRI personnel as well as her intent to hinder the

Division's investigation by initially providing misleading information and thereafter refusing to provide documents and testimony required by the two ABDs.

Accordingly, for her misconduct, Chew is permanently barred from associating with a registered public accounting firm.

B. Civil Monetary Penalty

Sections 105(c)(4)(D) and 105(c)(5) of the Sarbanes-Oxley Act specify maximum civil monetary penalty amounts, and these specified amounts are subject to periodic penalty inflation adjustments as published in the Code of Federal Regulations. *See* Inflation Adjustments to the Civil Monetary Penalties Administered by the Securities and Exchange Commission (as of Jan. 15, 2022), available at www.sec.gov/enforce/civil-penalties-inflation-adjustments.htm. For violations by a natural person after November 3, 2015, that involve intentional or knowing conduct, including reckless conduct, or repeated instances of negligent conduct, the maximum penalty amount is $1,144,186 per violation. *Id*. Here, the evidence submitted by the Division in support of the Default Motion establishes that Chew acted intentionally or knowingly.

In determining whether a civil monetary penalty is an appropriate sanction and, if so, the amount of the penalty, the Board has stated that it is "guided by the statutorily prescribed objectives of any exercise of [its] sanctioning authority: the protection of investors and the public interest." *Larry O'Donnell, CPA, P.C.*, at 9 (citations omitted). The Board has also stated that it will consider the factors set forth in Section 21B of the Securities Exchange Act of 1934, as amended. Those factors include (1) whether the conduct for which a penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard for a regulatory requirement; (2) harm to other persons resulting directly or indirectly from the conduct; (3) the extent to which any person was unjustly enriched; (4) whether the person against whom a penalty is being assessed has been previously found by the Commission or another agency to have violated federal securities laws, state securities laws, or applicable rules, or has been enjoined from such violations or convicted of certain offenses; (5) the need to deter that individual and others from such conduct; and (6) such other matters as justice may require. *See Dube,* PCAOB File No. 105-2014-005, at 6; *Joseph Troche, CPA*, PCAOB File No. 105-2014-007, at 11 (Mar. 6, 2015). Section 21B does not require that all of these factors be present as a condition to imposing a penalty, but rather sets them out as factors to be considered. *Dube*, PCAOB File No. 105-2014-005, at 6*; Troche*, PCAOB File No. 105-2014-007, at 11; *see also Next Financial Group, Inc.*, I.D. Rel. No. 349, 2008 WL 2444775, at *49 (June 18, 2008).

In this case, the Division seeks a $100,000 civil monetary penalty against Chew. The Division is correct that Chew's conduct was sufficiently egregious to warrant a significant monetary penalty. As the Board has made clear, refusals to cooperate with inspections and investigations, and inappropriate alterations of audit work papers, will be met with significant sanctions. Such misconduct causes at least indirect harm to investors that may be impossible to quantify, and also thwarts the PCAOB's ability to identify and rectify violations of statutes, rules, and standards that the PCAOB is charged with enforcing. *See Larry O'Donnell, CPA, P.C.; Davis Accounting Group, P.C. and Edwin R. Davis, Jr., CPA*, PCAOB File No. 105-2009-004 (Mar. 29, 2011), *app. for review dismissed*, SEC Rel. No. 34-65581, 2011 WL 4954239 (Oct. 18, 2011); *R.E. Bassie & Co.*, PCAOB Rel. No. 105-2009-001 (Oct. 6, 2010), *aff'd*, Rel. No. 3354, 102 S.E.C. Docket 2932, 2012 WL 90269 (SEC Jan. 10, 2012).

Chew's conduct involved fraud and deceit. Initially, she intended to deceive DRI inspectors about the work performed during the Subsidiary Audit and devised a plan that she believed would conceal improper alterations to work papers in anticipation of an inspection. When questioned about those modifications during the Firm's internal investigation, and later in an informal request sent by DEI, Chew asserted the false excuse that the changes to the work papers were part of the local statutory audit of Issuer A's Asian subsidiary. Chew's misconduct continued when she disregarded her regulatory obligation to respond to the April ABD and the May ABD.

There is a significant need to deter conduct like Chew's by any similarly situated parties in the future. For the PCAOB to discharge its statutory duties, it must rely on associated firms and their registered persons to be cooperative and candid during inspections and investigations.

In recent litigated orders concerning noncooperation with either a DRI inspection or an investigation by the Division, the PCAOB has imposed significant civil monetary penalties. *See, e.g., Freddy*, PCAOB File No. 105-2017-001, *Order Summarily Affirming Initial Decision* at 5 (Nov. 2, 2017) ($50,000 civil money penalty for noncooperation with a PCAOB investigation); *Farhang*, PCAOB File No. 105-2016-001, Final Decision at 28 (Mar. 16, 2017) (same); *Kabani*, PCAOB File No. 105-2012-002, at 19 ($100,000 civil monetary penalty for noncooperation with a DRI inspection).

Taking all of the relevant factors into consideration, the $100,000 penalty sought by the Division is appropriate to accomplish the Board's remedial objectives in this proceeding without being excessive or oppressive. While $100,000 is well below the maximum penalty that could be imposed, it nonetheless reflects the seriousness of the violations and will send a sufficiently strong message to Chew and others who are similarly situated of the consequences of deliberately choosing not to cooperate with a Board inspection, a Board investigation, or otherwise failing to comply with the Board's rules.

V. RECORD CERTIFICATION

Pursuant to PCAOB Rule 5202(d), I certify that the record includes the items set forth in the Record Index issued by the PCAOB Secretary and served on the parties on July 13, 2022.

VI. ORDER

For the foregoing reasons, to protect the interests of investors and the public interest, it is **ORDERED**, pursuant to Section 105(b)(3) of the Sarbanes-Oxley Act and PCAOB Rule 5300(b), that, Respondent Hui Yi Chew is barred from associating with a registered public accounting firm, and Respondent Hui Yi Chew is assessed a civil monetary penalty of $100,000.

This Initial Decision will become final in accordance with PCAOB Rule 5204(d)(1) upon issuance of a notice of finality by the Secretary. Any party may obtain Board review of this Initial Decision by filing a petition for review in accordance with PCAOB Rule 5460(a), or the Board may, on its own initiative, order review, in which case this Initial Decision will not become final.

Dated: August 10, 2022

Marc Dorfman
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Marc B. Dorfman
Chief Hearing Officer