

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
ROBERT D. POTTS, CPA

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INITIAL DECISION

Washington, D.C.
May 18, 1994

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Edward J. Kuhlmann
Administrative Law Judge

The respondent Robert D. Potts (Potts) is a certified public accountant licensed to practice in the State of Minnesota. During 1988, 1989, and 1990 Potts was an accountant with the accounting firms of Touche Ross & Co. and Deloitte & Touche and was the concurring partner for the fiscal year 1988 and 1989 audits of Kahler Corporation. His job as concurring partner was to provide additional assurance to the Touche audit team that the Kahler financial statements were presented in conformity with generally accepted accounting principles (GAAP) and that the Touche reports were prepared in accordance with generally accepted auditing standards (GAAS). Ex. 167. In both 1988 and 1989, Potts signed documents indicating that he had reviewed the financial statements at issue and the audits of them, and concluded that they satisfied the standards of the profession. Exs. 27 and 53.

Kahler's consolidated financial statements for those years were included in filings made with the Commission. The order instituting this proceeding alleges that Potts engaged in improper professional conduct in connection with the audits. The proceeding was instituted pursuant to Rule 2(e) (1) of the Commission's Rules of Practice (17 C.F.R. § 201.2 (e) (1)) to determine whether the allegations are true; whether Potts should be censured or temporarily or permanently disqualified from, and denied the privilege of, appearing and practicing before the Commission; and whether other relief, as may be determined to be appropriate, should issue.

A public hearing was held on September 23, 24, 27, 28, 29, 30 and October 1 and 4, 1993. The record was closed on October 4, 1993. The Office of Chief Accountant (OCA) filed proposed findings and conclusions on November 17, 1993 and Potts filed proposed findings and conclusions and a brief on December 23, 1993. OCA filed a reply and memorandum on January 14, 1994. On January 21, 1994, the Commission issued an order remanding Potts' motion to dismiss, that he had filed during the course of the hearing, for resolution in light of the hearing record.

FINDINGS OF FACT

The Audited Entity, Kahler, and Kahler Officers and Directors

Kahler is a corporation organized under the laws of the State of Delaware, with its principal offices located in Rochester, Minnesota. Jt. Stip. ¶ 1. During the period covered by the financial statements at issue, Kahler engaged primarily in the business of owning and managing hotels. Id. During 1987 through 1990, and continuing today, Kahler's securities were registered under Section 12(b) of the Securities Exchange Act of 1934, 15 U.S.C. 781(b), requiring Kahler to file periodic reports with the Commission pursuant to Section 13(a) of the Exchange Act, 15 U.S.C. 78m(a); Jt. Stip. ¶ 3. In 1988 and 1989, Kahler's common stock traded over-the-counter in Rochester, Minnesota and in New York. Id. at ¶ 2. Over 1,500,000 shares of Kahler's shares were outstanding to over 600 shareholders of record in those years. Id.; Exs. 86A at 21, 90A at 23. The Mayo Foundation is Kahler's largest

stockholder and controls over 30 percent of Kahler's stock. Exs. 86 at Proxy Statement 3; 90 at Proxy Statement 3.

Although the company has never had a public offering of its securities, it did privately place \$3,546,000 of cumulative convertible exchangeable preferred stock in December 1989 which was bought by, among others, the Mennonite Retirement Trust, the Mennonite Automobile Aid, Inc., the Mennonite Mutual Aid Assoc., the Motor Club of Iowa, the Richard M. Lucas Cancer Foundation, the Royal Neighbors of America, and the Catholic Order of Foresters. All purchasers received the 1988 Kahler annual report on Form 10-K. Ex. 90 at Item 14(a)(3) and exhibit 4(e), and Letter to Shareholders.

Kahler reported net income of \$1,428,000 during fiscal year 1986, net income of \$65,000 during fiscal year 1987, net income of \$239,000 during fiscal year 1988, a net loss of \$1,842,000 during fiscal year 1989, and net income of \$111,000 during fiscal year 1990. Jt. Stip. ¶ 6.

In 1985, Harold W. Milner became the Chief Executive Officer and Chairman of the Board of Kahler. He began a program of expanding the company, increasing the number of its hotel properties as well as the number of states where its hotels were located. Ex. 90A at 1-2. In January 1989, Touche indicated in their audit risk assessment that Milner took an "unduly aggressive" approach toward financial reporting; the Touche auditors were aware of this by the time of the 1988 audit. Exs. 219 at 1148; 36 at 1. According to the Touche auditors, Kahler's management level

accounting and financial personnel lacked the backbone or persuasive ability to check Milner's aggressive accounting policies. Exs. 36 at 1; 135 at 4. Gregory Melsen, the Touche engagement partner on the Kahler audits, noted in one memo that discussions with Milner were "challenging particularly related to significant transactions or the application of certain accounting principles and auditing standards." Ex. 36 at 1. Milner was replaced as Chairman of the Board in December 1989. Ex. 61 Tab 25. Nevertheless, the auditors told Kahler's audit committee that management continued to account for its business transactions aggressively, even during the SEC inquiry. Ex. 135 at 4.

Steven R. Stenhaug was the Vice President and Treasurer of Kahler during 1988, 1989 and 1990. Jt. Stip. ¶ 4.

On September 24, 1993, the Commission issued Findings and a Cease and Desist Order against Kahler, Milner and Stenhaug. The Commission found that, in 1988 and 1989, Kahler had used improper accounting practices and made inadequate disclosure that resulted in material misstatements of pre-tax income during those years. The company was required to restate its financial statements for those years. In re Kahler Corp., 55 SEC Docket 0024 (Sept. 17, 1993).

During 1988, 1989, and 1990, Donald C. McIlrath, John H. Herrell, John Sagan, Willis K. Drake, and Donald L. Lucas served on the audit committee of Kahler's Board of Directors. In 1989, John Herrell, the Chief Financial Officer and Treasurer of the Mayo Foundation, replaced Milner as Chairman of Kahler. Jt. Stip. ¶ 5.

The University Park Hotel and Kahler's Accounting for Its Acquisition and Potential Sale

On April 9, 1987, Kahler acquired the University Park Hotel in Salt Lake City, Utah by purchasing the stock of the two partners in University Inn Associates. The hotel was not completely constructed and was not operational at the date of purchase. The hotel began operation on October 31, 1987 and it was substantially completed on November 15, 1987. Jt. Stip. ¶ 10. In 1987, Kahler capitalized as pre-opening costs all the operating costs, deferred financing costs and other costs of UPH. Exs. 210 at 1561; 213A, 213H, 22A; Tr. 218-20, 223. They were not amortized in 1988 or 1989. Id.

In April 1988, the Kahler Board authorized management to explore the possibility of selling an interest in the hotel. Ex. 61 Tab 11. A copy of meeting minutes was in the 1988 Touche "Audit Working Paper Folder" or Top File. Ex. 220 at 139-42. (Touche labeled the file "Audit Paper Working Folder" but throughout the record of this proceeding it has been referred to as the "Top File.") Potts told the Commission during the investigation that he normally read the minutes and that the minutes of the April 1988 meeting were familiar. Ex. 23 at 36-37.

Kahler formulated at least 12 investment proposals over the course of two years seeking investors to participate in the ownership of the hotel. Exs. 101-13. None of the proposals would have been a sale for accounting purposes as provided in FAS [Financial Accounting Standard] 66. The proposals contained a

sales price that was less than the carrying value of the asset and would not have enabled Kahler to recognize a gain. Ex. 101-13; Ex. 23 at 22; Ex. 39; Ex. 236; Tr. 325-41.

Kahler's September 1988 minutes also indicate that Kahler was looking for a purchaser to "share in the ownership" of the UPH and those minutes were also in Touche's Top File. Ex. 61 Tab 13; Ex. 220 at 146-48. Potts stated that he could not recall having seen these minutes although he might have. Tr. 1213.

In December 1988, Kahler engaged a local Minneapolis investment banking firm, Piper, Jaffray & Hopwood, to sell a 50-percent interest in an investment partnership whose assets consisted of the UPH and one other hotel. Kari Brenna, who worked on the proposed sale at Piper Jaffray & Hopwood, stated that the firm did not specialize in selling hotels and that before the Kahler proposal she did not have any experience in selling hotel interests. Tr. 73, 75-76. Brenna was told by Kahler's treasurer and vice president, Steven Stenhaus, to sell no more than a 50-percent interest because Kahler wanted to continue to own the other 50 percent. Tr. 78-79, 108-13, 138, 146. She told Kahler that potential investors had told her that they would only be interested in 100 percent of the ownership. Tr. 91-97, 97-98.

Potts said that he knew that Kahler had told Piper, Jaffray & Hopwood to sell only a 50-percent interest and he was concerned about the implications that it had on the accounting treatment of the hotel. He never contacted, or had anyone else contact Brenna about whether she was trying to sell 100 percent ownership in the

hotel. Tr. 1222-23. Stephen Rushmore, a hotel valuation and marketing expert, also stated that in 1988-89, it would not have been likely that anyone would want to buy only a 50-percent interest, that a buyer would have wanted a controlling interest. Tr. 1677-78.

In September 1990, Kahler sold to Leroy Robert Allen and Olympusco, or granted them an option to acquire, all the stock of the partners of University Inn Associates, the owner of the UPH. The buyers paid Kahler \$300,000 and paid University Inn Associates \$1,300,000 and gave a \$500,000 note for the leasehold interest. Kahler funded a \$4,620,000 second mortgage on the hotel with a 15-year term, subordinated to the payments on the industrial revenue bonds. The buyers were guaranteed certain base funds. Kahler remained a one percent general partner, agreed to share in increases in land rent, to convert its mortgage into a 60 percent equity interest after the eighth year, to receive a percentage of excess funds, and to decide when to expand the hotel and to fund the expansion. Exs. 202 at Proposal and Purchase Agreement; 114.

The accountants determined after examining FAS 66 that the transaction was an arrangement to share in cash flows and was neither a sale nor a partial sale of the hotel. The accountants treated the transaction for book purposes as a sale of 30.5 percent of Kahler's interests in the hotel with no gain. Exs. 202 at Accounting Summary of Transaction; 51, 170.

Kahler's Financial Statements

Kahler's financial statements at issue are those for the fiscal years ended January 1, 1988 and December 31, 1989 and it is the manner in which they accounted for Kahler's University Park Hotel that is the focus of this proceeding. The financial statements consist of Kahler's consolidated balance sheets, consolidated statements of operations, consolidated statements of cash flows, consolidated statements of shareholder equity for the relevant periods and the notes to the consolidated financial statements. Exs. 86A at 12-19, 90A at 14-22. They were included in reports on Form 10-K that Kahler filed with the Commission on April 3, 1989 and March 28, 1990 (Exs. 86, 90), and in the annual reports that were circulated to shareholders and prospective investors. Exs. 86A, 90A.

Kahler reported to the Commission in its annual report for fiscal year 1988 that a "property acquired in 1987" (UPH) was being held for sale at a value of \$16,532,000. Ex. 86A at 12 and 17 n.4. The losses of \$1,347,000 associated with the property were excluded from the statement of operations and capitalized. Id. at n.4. The testimony of accounting expert Charles A. Werner, a tenured associate professor of accounting at Loyola University in Chicago, and an assessment by Touche's auditors states that the effect of deferring these losses was material to the financial statements. Tr. 240; Ex 219A. If the losses associated with the property had been reflected on Kahler's statement of operations, the results in

1988 would have been a net loss of \$1,108,000 instead of the \$239,000 gain posted. Ex. 86A at 14; Tr. 239.

In its annual report for fiscal year 1989, Kahler continued to defer the losses associated with the asset held for sale, but as of December 31, 1989, it moved the asset back on to the balance sheet at the same value reported at the end of the prior year, \$16,532,000. Ex. 90A at 14 and 19 n.4. Depreciation and amortization of the property did not commence until 1990. Ex. 90A at 19 n.4. The effect of deferring the losses associated with the asset held for sale during fiscal year 1989, Werner testified, and the auditors found, was also material to the financial statements. Ex. 224R; Tr. 413. If the losses had been included in the operating statement, the net loss for that year would have been \$2,808,000, instead of the \$1,842,000 loss reported. Ex. 90A at 16.

The Auditors

The public accounting firm of Touche Ross & Co. audited Kahler's FY 1987 and 1988 financial statements. Joint Stipulations of Fact ¶ 7; Exs. 82, 86A at 20. The public accounting firm of Deloitte & Touche, which was the successor to Touche Ross & Co. following a merger on December 3, 1989, audited Kahler's financial statements for FY 1989 and 1990 (both firms are referred to herein as Touche). Jt. Stip. ¶ 7; Exs. 90A at 23, 94. Kahler's Forms 10-K during this period contain auditors' reports issued by Touche. Exs. 82, 86, 90, 94.

In 1987, 1988, 1989, and 1990, Touche represented that the auditors examined the financial statements in accordance with GAAS and that in the auditors' opinion Kahler's financial statements were fairly presented in conformity with GAAP. Exs. 82; 86A at 20; 90A at 23; 94.

Touche follows an "engagement team" approach for each audit engagement. The engagement team consists of engagement management, in-charge accountants and associates. 1/ The respondent, Robert D. Potts, was the concurring partner for all of Touche's audits of Kahler's financial statements. Amended Answer ¶ 12; Jt. Stip. ¶ 8. Potts was also the client service partner for Kahler prior to the audits at issue (Jt. Stip. ¶ 8; Tr. 1076-77), and for the Mayo Foundation, Kahler's largest shareholder, throughout the relevant period. Tr. 1076. The client services partner is responsible for the delivery of all services and on-going business consultation. Ex. 25 at 10.

Potts is 51 years old, a certified public accountant and member of the American Institute of Certified Public Accountants

1/ The Touche engagement partner for Kahler's 1988 and 1989 audits was Gregory J. Melsen. Melsen is a certified public accountant and was a partner with Touche during the relevant period but he is no longer employed at Touche. Amended Answer ¶ 11; Tr. 1208. Prior to the hearing in this matter Melsen entered into a settlement with the Commission. In its Opinion and Order Imposing Sanctions, the Commission found that Melsen had engaged in improper professional conduct in connection with the 1988 and 1989 Kahler audits by, among other things, failing to obtain sufficient competent evidence to support a critical accounting transaction and failing to ensure that certain required disclosures were made in the notes to the Kahler financial statements. In re Melsen, 55 SEC Docket 0038 (Sept. 17, 1993).

(AICPA). Tr. 905; Amended Answer of Robert D. Potts (Amended Answer) ¶ 12. Potts became a partner in the firm of Touche Ross & Co. in 1975 (Ex. 23 at 6) and a partner in the merged firm of Deloitte & Touche on December 3, 1989. Ex. 239 ¶ 3. In 1988, he became the managing partner of Touche's Minneapolis office. Jt. Stip. ¶ 8; Tr. 906. As of August 30, 1993, Potts left his employment at Touche and currently works as a consultant to the chief executive officer at Greentree Financial Corp., a public company for which Touche has conducted audits, located in St. Paul, Minnesota. Id. at 905-06, 1200.

Under Touche's Practice Policies Manual (Ex. 242), Potts was responsible for objectively challenging the engagement partner (Ex. 242 at ¶ 15.110) and had to be satisfied that all questions had been appropriately resolved before signing the report docket. The signing of the report docket signified that he had determined that the financial statements were in conformity with GAAP, that the report on the financial statements were in accordance with generally accepted auditing standards, that he had performed an objective evaluation of significant accounting, auditing, and reporting considerations, and had resolved any questions regarding significant accounting, auditing, and reporting considerations. Ex. 242 at ¶ 15.400.

All members of the American Institute of Certified Public Accountants ("AICPA") are required to comply with the standards set by the SEC Practice Section if their firm is a member of the Practice Section or face action by the AICPA. AICPA Professional

Standards (CCH) Ethics Rule (ET) § 202, By-Law (BL) § 3.6, and BL § 360R.02. Potts was required to meet the requirements of the SEC Practice Section individually as a member of the AICPA. AICPA BL § 720.1. Under the Minnesota Code of Professional Conduct for accountants, Potts was required to adhere to GAAS and GAAP. See Minn. R. 1100.4800 and 1100.4900 (1987) reprinted in Accountancy Law Rep. (CCH) ¶ 25,714 at 6053.

The hearing testimony indicates that Potts has practiced before the Commission during at least 1978-1990. In 1978, Potts had primary responsibility for the audit of Gelco Corporation as the Touche engagement partner. Tr. 917-18, 1198. That audit was the subject of a Rule 2(e) proceeding against Touche, and Gelco ultimately was required to restate its financial statements. In re Touche Ross & Co., 29 SEC Docket 179 (Nov. 14, 1983). Ex. 244. The Commission found that Touche failed to obtain "the basic piece of evidence necessary for a complete understanding" of a critical transaction. The Commission noted that the auditors attempted to ascertain the industry practice of accounting for the transaction by reviewing the annual reports of three of Gelco's competitors, but that they drew "an incorrect inference from the reports that Gelco's competitors accounted for [the transaction] in a similar fashion." Id. The Commission concluded that despite the clear and contrary nature of the audit evidence, Touche improperly concurred with Gelco management on the accounting treatment. Id.

Accounting and Professional Standards Applicable to the Kahler Audits and to Potts in His Role as Concurring Partner

All certified public accountants engaged in the audits of public companies must adhere to generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) and Regulation S-X, the Commission rules governing the form and contents of and requirements for financial statements filed with the Commission. Potts, as a member of the AICPA, must also adhere to the Ethics Rulings of the AICPA. AICPA ET §§ 202, 203; Tr. 636-38, 653, 655-56. An auditor should not express an unqualified opinion as to financial statements that contain a material departure from GAAP. AICPA ET § 203; SAS [Statement of Auditing Standards] 5 [superceded by AU § 411], U.S. Auditing Standards (AU) § 411.06.

Ethics Rule 201 required that Potts exercise due professional care in the performance of his professional services and to obtain sufficient relevant data to afford a reasonable basis for his conclusions. Dr. Barry Epstein^{2/} pointed out that this included compliance with the standards promulgated by the FASB, the Accounting Principles Board and Auditing Standards Board. Tr. 653, 655-56; ET 202. Ethics Rule 203 provides that accountants involved in an audit cannot express an opinion or state affirmatively that the financial statements were presented in conformity with GAAP,

^{2/} Dr. Barry Jay Epstein, a CPA, is in charge of quality management which includes insuring compliance with GAAP, GAAS and other applicable professional standards at Checkers Simon & Rosner, a single office firm in Chicago, Illinois. He also performs the concurring partner reviews on all of the firms SEC engagements. Epstein has conducted between 30-40 such reviews in the last seven years and at least one of them involved the application APB [Accounting Principles Board] 30.

or that he was not aware of any material modifications that should have been made to the statements in order for them to conform to GAAP, if the statements contained any departures from the authoritative pronouncements which were material to the statements taken as a whole.

Edward J. Kerans is in charge of business assurance for the midwest offices of Coopers & Lybrand. He explained that the responsibilities of the concurring partner include spending whatever amount of time is necessary to properly fulfill his role and responsibilities, review the financial statements in an objective way, ensure that there are summary memoranda prepared for significant issues and review those memoranda, review the audit procedures, the Top File memoranda, and specific checklists, ensure that all required procedures are carried out and completed, investigate and challenge all decisions made in significant areas of the audit, understand the engagement, its problems and sensitive areas, know enough to ensure that all relevant facts and circumstances are marshalled, become satisfied with the answers received and the resolution of all questions raised by the audit, determine whether the assertions in the financial statements are appropriate and not in conflict with management's assertions in the discussion and analysis part of the annual report, and determine whether the financial statements are in accordance with GAAP and audited in accordance with GAAS. Tr. 1578, 1439, 1449, 1450, 1453, 1452, 1582, 1573, 1565-66, 1548-49, 1450, 1581.

In June 1973, the Accounting Principles Board issued APB Opinion 30, "Reporting the Results of Operations -- Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." The opinion specifies the "accounting and reporting for disposal of a segment of a business," and the "disclosure requirements for other unusual or infrequently occurring events and transactions that are not extraordinary items." APB 30 is intended to "ensure uniformity in practice and to stop manipulation of the income statements by not reporting operating losses." APB 30 ¶ 3; Tr. 172-73.

Touche and Potts were bound by AICPA Ethics Rule 203 to comply with APB 30 in accounting for Kahler's University Park Hotel. Tr. 173-74. APB 30 specifies the conditions under which operating losses need not be reflected on the income statement. First, management with authority to do so must commit, on a date certain, to a formal plan to dispose of the segment, whether by sale or abandonment. APB 30 ¶14. Second, the formal plan must identify the asset to be disposed of, the method of disposal, the period expected for completion of the disposal from the date that the formal plan was established (the measurement date), initiate an active program to find a buyer, provide an estimate of the results of operations of the segment from the measurement date to the disposal date, and estimate the proceeds to be realized from the disposal.

Third, a determination must be made at the measurement date of whether a gain or loss will result from disposal based on

estimates at that date of the net realizable value of the segment after giving consideration to costs and expenses directly associated with the disposal and estimated income or losses from operations from the measurement date to disposal. APB 30 ¶ 15.

And, fourth, if the period of disposal is revised to a period of time longer than one year, the net realizable value of the segment must be revised and the revision treated as a change in estimate.

Professor Charles A. Werner, a CPA and an expert in the fields of accounting and auditing and the role of the concurring partner (Ex. 166; Tr. 160), testified that if a loss is expected from the sale, the estimated loss should be provided for at the measurement date. If a gain is expected, he stated, it should be recognized when realized. Tr. 180-84, 187.

When disposal accounting treatment is appropriate, the financial statements must disclose the results of the operations of the disposed segment as a separate component of income pursuant to APB 30 ¶ 8, or below the line from continuing operations. It is also required that revenues applicable to all discontinued operations of a segment be separately disclosed in the notes to the financial statements. The notes to the financial statements for the period encompassing the measurement date and subsequent periods should identify the segment, expected date of disposal, expected manner of disposal, description of the remaining assets and liabilities of the segment, and the income or loss from operations

from the measurement date, as compared with prior estimates. APB 30 ¶ 18.

The Emerging Issues Task Force (EITF), which is a separate committee of the Financial Accounting Standards Board (FASB), issues consensus positions on existing GAAP. Tr. 675-76. In 1985 and 1986, EITF reached a consensus, EITF 85-36, that operating losses between the measurement date and the disposal date should be deferred until disposal only if there is reasonable assurance of an overall net gain anticipated on disposal. Consistent with APB 30, it was the consensus of EITF that following from Accounting Interpretation 1 this treatment of losses should also apply to the sale of a significant portion of a business that is not a segment as defined in APB 30, assuming that the other related requirements of APB 30 are satisfied. The conditions and requirements of APB 30 must apply during the entire period the segment or significant portion is being treated as a segment. Tr. 381, 590.

Professor Werner testified that under APB 30 the asset's value is what it could presently bring under the method of planned disposal, not the long term recoverability through future cash flows. Tr. 380. It would be inappropriate, he said, to look at the long-term recovery value or what could be derived from the asset over time by operating it, if the company intends to sell by a target date. Tr. 381.

Financial Accounting Standards (FAS) 66 explains how to account for real estate sales. If the transaction does not meet the sale requirements of FAS 66 then the gain cannot be recognized

and the losses cannot be capitalized under APB 30.^{3/} Professor Werner explained that, while FAS 66 provides for the recognition of a partial sale, APB Opinion 30 requires the disposal of the entire segment or significant portion of the segment to be treated as an asset held for sale, instead of a depreciable asset. Tr. 185.

Information Available to Pott's About the Accounting at Issue

The Plan to Sell UPH

Potts said that he first learned that Kahler was interested in treating the UPH as a discontinued segment under APB 30 during a luncheon meeting he attended with Harold Milner, Chief Executive Officer and Chairman of the Board of Kahler, Steven Stenhaus, Vice President and Treasurer of Kahler, and Gregory Melsen, the Touche engagement partner on the Kahler audit, at the Minneapolis Club in March 1988. Tr. 946-49; Ex. 23 at 7.

The meeting occurred before the time that the 1987 financial statements and annual report were filed in the Form 10-K with the Commission on March 30, 1988 and Potts stated that the purpose of the lunch was to wrap up the 1987 audit. Tr. 947. Potts explained that the discussion of the accounting treatment for the UPH was very limited and that it centered on the disclosures that would

^{3/} Under FAS 66 a profit or gain on a sales transaction may be recognized if a sale is consummated, the buyer's initial investment is adequate to demonstrate its commitment to pay for the property and indicates a reasonable likelihood that the seller will collect the receivable, the seller's receivable is not subject to future subordination, and the seller has transferred to the buyer the usual risks and rewards of ownership in a transaction which is in substance a sale and the seller does not have a substantial continuing involvement with the property.

have to be made in the financial statements. Tr. 948-49. The Kahler officers asked whether Touche knew "any people who might be interested in investing ... in a hotel." Tr. 957. On April 15, 1988, Milner prepared a memorandum for the Kahler Board of Directors stating that Touche had advised Kahler that, if the company had a reasonable plan for sale and was working on it, it could book the hotel as an asset held for sale rather than as a depreciable asset. Ex. 64.

Potts maintained that the discussion of the accounting treatment of the UPH at the March lunch lasted for two or three minutes, and that none of the things mentioned in Milner's memo were discussed. Tr. 1217. However, in his investigative testimony taken two and a half years ago, before his memory was "refreshed" (Tr. 1073), and before Potts became a respondent in this administrative proceeding, Potts testified about this same lunch as follows:

We also spent time at that point talking about how they would account for transactions like that, specifically the University Park transaction, and discussed a formal plan, disposition of the property, that they could potentially hold it as a property for sale on their financial statements, not depreciate the property, had to be aware of course at all times of net realizable value, that the value of the assets on the books was realizable * * *. Ex. 23 at 8; Tr. 1218.

According to Donald Moulin, a retired senior partner at KPMG Peat Marwick and an expert on the role of the concurring partner,^{4/} this lunch presented the first of four opportunities for Potts to take action to ensure that the accounting treatment for the hotel was proper. Tr. 763-65. Moulin, who served as the concurring partner on between 10 and 20 audits involving accounting transactions under APB 30 (id. at 747), testified that a reasonable concurring partner would have instructed the engagement partner to be sure that the client formulated a formal plan and prepared auditable estimates of the results of the disposition of the hotel. This work could then have been memorialized in a memo for the Top File which the concurring partner could review. Id. at 763-65.

Dr. Epstein stated that Kahler's financial statements at year-end should have indicated to Potts that the accounting for the UPH was a material audit issue. He explained that the cost and loss deferral of UPH was four times the reported earnings in 1988 and therefore anyone looking at the financial statements would realize that the accounting for UPH was material. Ex. 86A; Tr. 533-34. Mr. Moulin also testified that the accounting treatment for the UPH should have put Potts on notice that UPH was a material issue. 761-62, 769-70; see also Ex. 220M.

Moulin explained that APB 30 requires that there be a plan for the disposal of a segment and the plan must be documented. APB 30 ¶ 14; Tr. 747-48. Potts, during his investigative testimony,

^{4/} Moulin became an SEC review partner at Peat Marwick in 1972 and he has served on the Accounting Practice Committee and the Audit Committee.

defined a formal plan as existing when "the company's intent was laid out and documented as attested to by the Board and others." Ex. 23 at 59. Potts represented that the only such documentation he saw during the Kahler audit was the minutes of Kahler's "Board [which] had authorized the sale of the properties." Id. at 60; Ex. 61 Tab 11. Tom Bintinger, Touche's national director of accounting and auditing professional standards before the merger and after the merger the director of auditing services, explained that the April 1988 minutes in which the Board authorized the exploration of the sale of an interest in the hotel "would certainly seem to need some additional discussion" in order to constitute a formal plan. Tr. 1360. Dr. Epstein also concluded that the minutes of Kahler were insufficient to establish a plan for disposition under APB 30. Tr. 544-45.

Potts represented that he discussed with Melsen when the measurement date was and they agreed that it was "[s]ometime towards the end of the first quarter." Tr. 1106. Potts said that during the course of the audit Melsen told him that the company had adopted a plan to liquidate its interest, but Potts at no time asked to see the plan, nor was he ever shown a copy of the plan. Tr. 950, 1103.

The expert accounting witnesses concluded on the evidence of record that Kahler lacked a formal plan for the disposal of the UPH as required by APB 30 ¶ 14. Tr. 540, 545, 547, 562-63, 566, 588, 599, 773, 408. And it was their view that a formal plan was a requirement of APB 30. Tr. 178, 539, 548, 767. Moulin and

Epstein, who had served as concurring partners on audits involving transactions governed by APB 30, stated that they asked to see and were shown copies of the formal plan when APB 30 was applicable. They explained that the plans varied in style and presentation, but all of the plans were in writing and provided the required information. Tr. 747, 563.

Moulin testified that Potts as the concurring partner should have acquired evidence that Kahler had a formal plan and sought assurance that the Touche audit team had acquired sufficient evidence that Kahler had a formal plan satisfying the requirements of APB 30 ¶ 14. Tr. 747-48, 767. It was Epstein's opinion after reviewing the items Potts considered that without a formal plan he did not have sufficient competent evidence that the accounting for the UPH was correct. Tr. 539-40.

In connection with his year end review, Potts said that Melsen told him that during the audit he had "uncovered evidence ... that questioned the commitment of ... Kahler management to ... dispose their equity interest in this hotel." Tr. 954. Melsen told Potts about the Piper, Jaffray engagement letter and an investment proposal packaging the UPH with another Kahler hotel property. Tr. 954. Potts represented that during the course of his review he saw only the contract letter between Piper Jaffray and Kahler to sell a 50 percent interest in a hotel partnership. Id. at 954-55; Ex. 19.

Potts maintained that he did not see any of Kahler's investment proposals in 1988, nor ask whether any proposals were outstanding:

Q. Did you see any of the investment proposals in 1988?

A. No.

* * *

Q. Did you ask whether or not there were any investment proposals outstanding?

A. I did not. Tr. 956, 1109.

Potts admitted at the hearing that if he had been aware of the terms of the investment proposals, he would have further examined the accounting treatment of UPH. Tr. 1101. Potts' hearing testimony on the issue of whether or not he was aware of the investment proposals in connection with the 1988 audit contradicts his investigative testimony where he stated that prior to the issuance of the 1988 audit report he knew investment proposals existed and periodically saw proposals:

Q. Have you ever seen a sales proposal regarding the disposition of the University Park Hotel?

A. Yes.

Q. And when did you see those proposals?

A. I can't recall, periodically.

Q. Do you remember the first time you saw a proposal?

A. I think sometime prior to that meeting but I can't recall any more specifically than that.

Q. When you say "that meeting", which meeting are you referring to?

A. The meeting in '89.

* * *

Q. Have you seen sales proposals that are similar to Exhibit 6 or 7 in that they involve the packaging of the University Park Hotel with the Clinic View Inn?

A. I was aware of them. I don't know if I saw them.

* * *

Q. And when did you first become aware of them?

A. Sometime prior to the meeting in early 1989. Ex. 23 at 18-19, 33-34.

In any event, Potts admits that when he did become aware of the plan to sell the UPH and the Clinic View Inn, he and Melsen concluded that they needed to talk to Kahler management to determine the company's plans for the UPH. Tr. 955. Potts attended a meeting in Rochester, Minnesota with Milner and Stenhaug and possibly one other Kahler officer in February 1989 where Milner assured Touche that the company intended to sell its equity interest in UPH. Ex. 23 at 34; Tr. 958-59.

Potts represented that he instructed Melsen to meet with the Kahler audit committee to discuss this issue. After Melsen met with the audit committee, he told Potts that the audit committee had assured him of the company's intent to sell the hotel. Ex. 239 ¶ 9; Tr. 961-62. Potts did not instruct Melsen to have discussions with personnel at Piper Jaffray. Tr. 960-61, 133. Potts could not point to any documentary evidence which supported the oral representations of Kahler other than audit committee minutes which reiterated that the audit committee was satisfied with the Kahler's accounting treatment of the UPH. Ex. 61 Tab 17; Tr. 966.

Moulin and Epstein stated that unsupported management assertions do not constitute audit evidence. Tr. 759-60, 776, 554. Moulin and Epstein also testified that representations from the audit committee, whatever their credentials, do not constitute competent audit evidence. Tr. 759-60, 776-77, 717-18.

Bintinger, a current Deloitte & Touche partner called as a witness by Potts, also testified that conversation alone does not constitute competent evidence of material assertions in ordinary

circumstances. Tr. 1369. He said that only if something could not be documented would oral representations be competent audit evidence. Epstein and Moulin stated that a "formal plan" is something that could and should be documented; Moulin explained that the use of the word formal signified to accountants that the plan required documentary support. Tr. 538-40, 747-48; APB 30 ¶ 14.

Support for Net Realizable Value In the 1988 Audit

APB 30 requires that management prepare estimates of the gain or loss to be realized on the disposition. APB 30 ¶ 15. This requires calculating the net realizable value (NRV) of the property and estimating the losses to be deferred from the measurement date to the disposal date. Id. APB 30 contemplates that the NRV, which is used to determine gain or loss on disposal, should be an estimate of the amount to be received on disposal. Professor Werner and Stephen Rushmore 5/ testified that a buyer would not pay an amount based on cash flow that is not discounted to present value. Tr. 192-93, 1679-81.

Melsen stated in June 1989 that NRV was something that Kahler needed to "continually address ... and vigorously support." Ex. 42 at 3. Edward Kerans, who is a CPA, an engagement partner and concurring partner at Coopers and Lybrand's Minneapolis office, pointed out that the value of an asset held for sale must be

5/ Rushmore is a hotel valuation expert and the founder and President of Hotel Appraisals, Inc. He has written six textbooks on hotel valuation and numerous articles on topics including discount and capitalization rates in valuing hotels and the effect of interest rates on hotel values.

reassessed each quarter (Tr. 1520) and Touche's Bintinger concurred that it was Kahler management's job to supply the auditors with estimates of net realizable value and the auditors' job to audit it. Tr. 1362. The Touche National Office recommended that an appraisal was "one of the best levels of support for net realizable value." Ex. 42 at 3.

Despite this requirement, Touche's 1988 audit work papers do not contain management's estimates of NRV, nor is there an appraisal. Ex. 216. The only evidence regarding net realizable value in the 1988 work papers was a single page prepared by Kevin Moug, the Touche senior manager. Ex. 216 at 622-23. The work paper used two different approaches to derive NRV. Id. The first method utilized undiscounted cash flows over 40 years and the second compared the cost to build the UPH with the cost to build the Kahler Plaza, a hotel located in Rochester, Minnesota. Id.

Rushmore, who has substantial experience in buying hotels, pointed out that a typical purchaser of a hotel would not value a hotel in the manner used by Touche to assess the value of the UPH in 1988. Tr. 1679-81. He said it would not be reasonable to use, as Kahler did, a 40 year cash flow to value a hotel for sale. Tr. 1679-81. Professor Werner testified that the use of undiscounted cash flow was not appropriate for determining NRV as required by APB 30 because it does not "come up with any estimated value that could be the value within some reasonable period of time to dispose of the asset held for sale." Tr. 320-21.

Rushmore, Epstein, and Werner all agreed that Touche's only other test, comparing the construction costs of the luxury, upscale Kahler Plaza Hotel located in Rochester, Minnesota to the UPH, is not a valid method of determining net realizable value. Tr. 1679, 574-75, 317-23. Rushmore stated that construction costs are given very little weight in valuing hotels. Tr. 1679. He explained that comparing construction costs between two hotels in different markets with different features, different qualities and different characteristics, as the auditors did in an attempt to assess the value of the UPH in 1988, is not a valid method of calculating NRV. Tr. 1679.

Potts' hearing testimony and investigative testimony are contradictory as to whether he reviewed the NRV analysis in connection with his review of the 1988 audit. At his deposition, prior to being shown any documents, Potts testified that in 1988 Touche had analyzed the NRV of the hotel and when asked if he reviewed the analysis, stated "I remember looking at it in part at least." Ex. 23 at 44. He was then shown a copy of the work paper which was illegible. A second copy was provided and Potts stated that he could "see pieces of it" and it looked "like an analysis that I saw, yes." Id. at 44-45, Investigative Exhibit 47.^{6/} Since the exhibit was the only analysis of NRV in the work papers, Potts' identification of it as the work paper he saw was credible.

^{6/} At the hearing, the copy shown to Potts at his deposition was not available and the Division was asked to submit it for the record. That was done on November 18, 1994. Investigative Ex. 47 is received into evidence.

At hearing Potts was shown a copy of the same NRV work paper. Before a question could be posed, Potts testified, "No I've not seen this. I have not seen it." Tr. 984. On cross-examination Potts stated that he saw no analysis of NRV in 1988:

- Q. Did you see an analysis of net realizable value?
A. When?
Q. When you were doing your review of the audit of 1988.
A. I did not see this analysis, no.
Q. You did not see this.
A. I did not see this analysis. Tr. 1075.

He reconciled his differing testimony by explaining that when he saw a clearer copy of Investigative Exhibit 47 (sometime after his deposition) he realized that he had not seen it during the audit. Id.

Moulin and Epstein stated that a reasonable concurring partner would have exercised professional judgment and asked to see underlying work papers which support a significant audit issue like the NRV for the UPH. Tr. 769, 562-63. Dr. Epstein testified that the single 1988 NRV work paper did not provide adequate support to satisfy a reasonable concurring partner about Kahler's calculation of the NRV under APB 30. Tr. 574-75.

Potts agreed with Rushmore and Werner that by itself an undiscounted cash flow for 40 years based on the budget for the first two years of the hotel's operations would not have been sufficient evidence of NRV. Tr. 1231-32. He also agreed that he would not have considered a cost per room comparison of two hotels located in different places sufficient evidence of NRV. Id.

Bintinger of Touche's National Office stated that it was the engagement team's job to assemble the audit evidence supporting the accounting treatment of the UPH and it was Potts' job as concurring partner to challenge that evidence. Tr. 1355-56.

Application of APB 30 to the UPH in the Kahler Financial Statements in 1988

Dr. Epstein found in his review of Kahler's 1988 financial statements that they did not conform to the reporting requirements of APB 30 and were misleading to the average investor. Tr. 576-81. Dr. Epstein pointed out (referring to Ex. 86A at 3, 11 and 14) that the revenues generated from the UPH were highlighted in the Management Discussion and Analysis (MD&A), the President's Letter to Shareholders and included in the prominently featured Total Revenue figure, but not in the revenue of Kahler Corporation. Although Kahler owned 100 percent of the hotel in 1988, Kahler included the UPH's revenues in the category of "Managed" lodgings, meaning Kahler owned 50 percent or less of those properties. Epstein believed that this treatment was confusing to the reader of the financial statements.

Epstein said that it may have been appropriate to exclude UPH revenues from those of Kahler's because it was an asset held for sale, but then it was not appropriate to highlight them in the MD&A. He explained that the auditor is required by GAAS (SAS 8) 7/

7/ Compliance with auditing standard SAS 8 requires that an auditor read the other information in the 10-K report and "consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial (continued...)

to read all the information in the annual report, which is filed with the Commission, to ensure that contrary conclusions about the financial condition of the company presented by the auditors cannot be drawn from management's text. But even aside from his finding of conflicting treatment of the UPH's revenues by Kahler, he pointed out, the reader of its financial statements was not given the clear picture of UPH's revenues required by APB 30 ¶ 8 because they were not separately disclosed in a footnote as is required. Tr. 582-84. Dr. Epstein concluded that the discussion of Kahler's earning trend in the MD&A section of the annual report was misleading in light of the treatment of the UPH in the financial statements. Tr. 578-83.

Professor Werner pointed out that APB 30 requires, in addition, other footnote disclosures, including the identity of the discontinued segment. APB 30 ¶ 18; Tr. 312. Footnote 4 of Kahler's financial statements, provides only that the company "acquired a property in 1987" and reclassified it into assets held for sale at January 1, 1989 and the operating results of UPH a loss of \$1,347,000 were excluded from the income statement. The UPH is not listed by name, even though two hotels were acquired by

2/(...continued)

statements." AICPA AU § 550.04. Kerans, who appeared as a witness for Potts, agreed with Epstein, that the auditors have an obligation to read the 10-K and insure that it does not conflict with representations made in the financial statements. Tr. 1548. Werner, Epstein, and Moulin all stated that SAS 8 is part of the "ethically enforceable" auditing standards that apply to all accountants engaged in public accounting, including concurring partners. Tr. 526-27, 429-30, 826-27.

Kahler in 1987 (Ex. 82, Annual Report at 3 Letter to Shareholders) and construction was completed on two hotels in 1987. Ex. 86A at 1, 3 and n.4.

In his role as concurring partner Potts said that he did review Kahler's entire annual report, Kahler's Form 10-K and the financial statements of Kahler. Tr. 923, 1068. He maintains that the 1988 financial statements meet the disclosure requirements of APB 30 ¶ 18 because there were several references in the annual report to the fact that Kahler acquired the UPH in 1987. Tr. 994-95. Potts agreed, however, that nothing in the 1988 report stated that the UPH was acquired in 1987. But, he pointed out, anyone reading the report could have determined when it was purchased since it is mentioned in two or three places in the report that it was the first full year of operation of UPH. Tr. 1242. Whether the UPH should have been identified, Potts said, was something that he thought about when he reviewed the audit. Tr. 1243. After he looked at reports of the Marriott Corporation, he concluded that Marriott had not provided specific identification of its hotels and therefore identification was not necessary.

Moulin pointed out that Potts' review of the 1988 audit presented him with a second opportunity to consider the accounting treatment being applied to the UPH. Tr. 766-69. In his view a reasonable concurring partner would have then reviewed some work papers to verify Kahler's compliance with the requirements of APB 30. Id. Epstein, Moulin, and Werner concluded that Potts' failure to act as a reasonable concurring partner contributed to the fact

that the 1988 audit was not performed in accordance with GAAS. Tr. 585, 786-87, 408-09, 412-13.

THE 1989 AUDIT

The S-2 Filing

In 1989, Kahler prepared a public offering of 400,000 shares of its preferred stock. Ex. 22. In connection with that stock offering, it prepared a Form S-2 that contained the 1988 audited financial statements and unaudited financial statements for the first quarter of 1989. Ex. 98.

The text of the S-2 which prominently featured a picture of the UPH (one of only two properties pictured) states that 1988 investment activities related to "the acquisition of the [UPH]." Ex. 98 at 005, 022. One page later it states that Kahler "intends to offer interests in its hotel properties for sale" (id. at 023) on terms that will allow Kahler to continue managing the properties. It states that one hotel property is being offered for sale but does not name the hotel. It also indicates that if no sale is consummated or pending at year-end it will begin to include the results of operations from the property in the first quarter of 1990. Id.

Robert Hyde, the Director of Professional Standards Review for Touche's Twin Cities office was the concurring partner for the S-2 filing. Tr. 1004. In connection with certifying the financial statements for the S-2, Melsen, as engagement partner, and Hyde, as concurring partner, asked the Touche National Office in June 1989 regarding the permissible period for holding a segment of a

business out under APB 30. Ex. 42. Hyde's participation reflects Touche's policy on professional standards which provides that the concurring partner should be part of the research and consultation stream. Ex. 168 ¶ 15.300.

Dow Nelson, one of the Touche National Office partners consulted, prepared notes of this consultation indicating that his "best advice" was to write off in the decision period the previously capitalized losses excluding depreciation, get an appraisal to support the carrying value and to get the client to stop deferring. Ex. 38. This advice was not followed at that time by Kahler. Tr. 1368-69.

The SEC Informal Inquiry and Year-End Events

In July or August 1989, the Commission initiated an informal investigation into the accounting treatment accorded the UPH. Jt. Stip. ¶ 16; Tr. 1370, 1268. In September, the Commission sent a document request to counsel for Touche, including a request for any correspondence in Potts' files concerning the UPH. Ex. 241; Tr. 1267.

In December 1989, Kahler removed Milner as Chairman of the Board, replacing him with John Herrell, a Board member and officer of the Mayo Foundation. Ex. 61 Tab 25. Although not recorded in the Board minutes, at this same meeting, the Board unanimously concurred with an audit committee directive to management demanding simplification of its proposed transactions and development of "more conservatism in the company's financial statements." Audit Committee Chairman John Sagan informed Melsen about the committee's

view. Melsen included it in a memorandum for the Top File. Ex. 224 at 6535.

Melsen attended the February 9, 1990 audit committee meeting and in his notes, which were also part of the 1989 Top File, he stated that Dr. McIlrath "expressed concern regarding the Company's history of assembling aggressive projections." Ex. 224 at 6529-30.

The Accounting for the UPH in 1989

On the last day of fiscal year 1989, Kahler brought the UPH back onto its books as an operating property and distributed the book value of the hotel in various items under Property and Equipment. The book value of the hotel was not disclosed, but was represented to be "substantially similar" to the value at the beginning of the year. Ex. 90A at 14 and n.4. Kahler deferred the depreciation and capitalized the losses associated with the hotel for the entire year. Exs. 224 at 6596; 224D. The amount of the losses were not shown on the income statement nor were they disclosed in the footnotes. Ex. 90A at 14 and n.4.

Bintinger, Epstein, Werner, and Kerans testified that the requirements of APB 30 would have to be satisfied during the entire period that losses were being deferred, including that there be a reasonable expectation of a gain on disposition during the entire time the asset was being held for sale. Tr. 1361-62, 611, 381, 1520.

Melsen consulted with Dow Nelson and Tom Bintinger of Touche's National Office regarding the 1989 footnote disclosures related to

the UPH. Ex. 224 at 6562-63. Potts did not participate in the consultations (Tr. 1350, 1357) but was aware that they were taking place. Id. at 1264-65.

For purposes of bringing the hotel back onto the books as an operating property, the audit engagement team analyzed the estimated recoverable value of the hotel but not the net realizable value. The focus of the inquiry was whether a write-down of a long-lived asset was required in accordance with EITF 84-28, not whether a gain could reasonably be expected on disposal. Exs. 90A n.4; 224 at 6564-66; Tr. 1046-48.

In January 1990, Melsen asked Kenneth P. Riggs, MAI, of Touche's Chicago Valuation Office for "assistance in determining the fairness of the carrying value" of the UPH. Ex. 224I at 1. The auditors provided Riggs with a description of the property, a description of the land lease and the existing financing, the operating results from 1988 and 1989, and future projections. Id. at 1-2.

Riggs furnished his response on February 5, 1990. The analysis performed was based solely on an income approach which, according to Riggs, "is the best simulation of a buyer's decision process for this type of property and is the only approach that is capable of directly measuring the owner/lessor's marketable interest in the subject property." Ex. 224K at 2. The discounted cash flow analysis yielded a value of \$11,400,000 (id. at 5), which was well below the \$16,753,000 book value. Id.; Ex. 216 at 622.

The auditors altered the Riggs discounted cash flow in Table IV by substituting Kahler's projections for the industry projections and historical results used by Riggs and lowering the discount rate. Ex. 222 at 5577-80; Ex. 224F. The work papers do not explain or justify altering Riggs' projections and discount rate. Id.

Rushmore, in reviewing Riggs' analysis of market value in Table IV (Ex. 224K), agreed that he used an appropriate methodology to come to a discounted cash flow value of \$11,400,000, which was below book value. Rushmore also believed that Riggs use of a 14 percent discount factor and a rate of 11.5 percent for capitalization were appropriate. Tr. 1683-84. However, Rushmore and Professor Werner found that the return of capital calculation reflected in Table V was not a reasonable approach to market value because it was not discounted to present value. Tr. 1683-84, 393.

Rushmore found that the changes made by the accountants to Table IV (Exs. 222 at 5577-80, 224F) were not reasonable because the Kahler projections, which significantly increased figures used in the Riggs analysis, were very aggressive and not based on historical results, as were the Riggs figures, and the lowering of the discount rate was very aggressive. Tr. 1684. Actual results for the University Park Hotel in 1988 and 1989, as shown in the audit work papers, were three and four times less favorable than Kahler's projections (Exs. 218C, 223A), putting the accountants on notice of the very aggressive nature of the Kahler projections.

Professor Werner explained that the Riggs analysis of value was important in the 1989 Kahler audit to determine whether the UPH was accounted for appropriately under APB 30 during 1989. Tr. 394. He said that the Riggs analysis was the type of evidence that Kahler management should have furnished to the auditors to justify its expectation of gain on sale for purposes of APB 30. Tr. 391.

Potts examined both the Riggs Table IV analysis and the changes made to it in the work papers before the 1989 audit report was issued. Tr. 1072, 1127-28. On March 9, 1990, Potts signed the concurring partner checklist indicating that he had concluded that the financial statements were in conformity with GAAP and the Touche report in accordance with GAAS. Ex. 53. In January, February and March 1990, Potts billed a total of 17 hours to the Kahler engagement. Ex. 535.

The OCA's three accounting experts, Werner, Moulin and Epstein testified that the accounting treatment accorded the UPH in the 1989 financial statements was inappropriate and that the financial statements were not presented in conformity with GAAP, nor was the 1989 Touche audit performed in accordance with GAAS. Tr. 408-09, 786-87, 622.

Potts' Professional Conduct in the Face of Red Flags

Once Potts knew about the SEC investigation, he had a heightened awareness of the issues relating to the UPH's treatment as an asset held for sale (Tr. 1040), but the record does not reflect that he initiated a reexamination of the 1988 financial statements (Tr. 770), nor did he involve himself in the research

and consulting stream regarding the treatment of the UPH in the 1989 audit. Tr. 1350, 1357, 1030.

Moulin, who presented expert testimony on the role of the concurring partner, described the SEC investigation as a "blockbuster wake-up call." Tr. 772. His review of the record indicated that this was the third opportunity available to Potts to step in and ensure that the accounting treatment of the hotel was proper. Tr. 769-73. Moulin believed that, if appropriate procedures had been followed, Potts should have been part of the consultations with the National Office. Tr. 783.

In performing his review of the 1989 audit, Potts testified that he had in-depth discussions with Melsen, reviewed the Top File memoranda, reviewed the financial statements and annual report and relied on Melsen's recounting of advice he had received from the National Office. Tr. 1040-42, 1046-48, 1068-72. Potts took no steps to change the accounting treatment of the hotel in 1989, his fourth opportunity. Tr. 773-75.

Potts reviewed the Riggs valuation of the hotel and looked at the engagement manager's analysis concerning net realizable value. Tr. 1072. Based on the work Potts performed he knew that the losses, including depreciation associated with the UPH, had been deferred for all of 1989. Exs. 90A n.4; 224 at 6596; Tr. 1289-90. Bintinger, Werner and Epstein stated that in order to derive this benefit the requirements of APB 30 had to be satisfied. Tr. 1361-62, 590, 381.

Potts had available in the Top File one of Kahler's investment proposals (Ex. 224 at 6505-16) which would not have resulted in a gain or qualified as a sale. Ex. 222 at 5577 ("net book value at 12/31/89 - \$16,754,000"); Tr. 1642-45. In the face of contradictory documentary evidence and the absence of any other documentary evidence, Potts chose instead to rely on oral assurances from the engagement partner and the client. Ex. 239 ¶ 16; Tr. 1067.

Bintinger testified that he never saw any Kahler estimates of net realizable value and could only speculate that Dow Nelson, another person in the National Office involved in these consultations, had seen offers of sale or purchase. Tr. 1362-63. While the National Office agreed with the draft disclosure in footnote 4, he said that the National Office did not read the entire financial statements or the annual report; that job, he indicated was the responsibility of the engagement partner and concurring partner. Tr. 1356-57.

Potts indicates that he relied on Touche's National Office in his review of the footnotes. Professor Werner pointed out, however, that estimated recoverable value used in footnote 4 is different than net realizable value and is an inappropriate standard. Tr. 407. Bintinger agreed with Werner that it would have been appropriate for Kahler to defer the operating losses associated with the hotel for the entire year only if cost was less than net realizable value. Tr. 1361-62.

In 1989, the hotel was moved back onto the consolidated balance sheet and its book value was distributed in Property & Equipment in unspecified amounts. Ex. 90A at 14. The revenues from the UPH were included in the statement of operations in the category of "other properties managed and/or partially owned." It is also reflected in total revenues although it is not defined as such in footnote 1's description of other properties managed and/or partially owned. Kahler did not run any of the UPH losses through the income statement, although it did include the revenues generated by UPH in its total revenue figure. Ex. 90A.

Testimony About Potts Compliance with Rule 2(e)

Moulin, Epstein, and Werner concluded after reviewing the record that Potts' conduct constituted improper professional conduct within the meaning of Rule 2(e). Tr. 786-87, 585-86, 623-24, 411-14.

Moulin testified that on four occasions Potts had warning signs that the audit was not being properly conducted and the accounting needed to be corrected. He testified that in his opinion Potts "failed to act in a reasonable manner in carrying out his responsibility as a concurring review partner" and that that failure contributed to the violations of GAAP in the 1988 and 1989 financial statements and the violation of GAAS in the audits. Tr. 786-87.

Dr. Epstein testified with respect to the 1988 audit that Potts' conduct "was deficient and did not comply with professional standards," and similarly in 1989 he "did not fulfill his

responsibilities properly." Tr. 585, 623. Professor Werner characterized Potts' conduct as "unreasonable," "reckless" and "[m]ore than just careless." Tr. 411, 412.

All of the OCA's experts, Epstein, Moulin, and Werner, agreed that Potts could and should have corrected the accounting treatment being applied to the UPH and failed to do so. Tr. 584-87, 621-24, 763 et seq., 411-14.

CONCLUSIONS

Potts' Violation of Rule 2(e)

Robert D. Potts was the concurring partner on the Touche audit of the Kahler Corporation in 1988 and 1989. Those audits were not conducted in accordance with GAAS and the financial statements were not fairly presented in accordance with GAAP. Potts knew or should have known this; nevertheless, he concurred in the decision that led to the Touche firm issuing an unqualified opinion. The inaccurate financial statements were included with Kahler's Forms 10-K filed with the Commission on April 3, 1989 and March 28, 1990; in addition, they were sent to the stockholders of Kahler and potential investors.^{8/}

Potts is a CPA who belongs to AICPA and has practiced before the Commission for over 15 years. Touche, his accounting firm, has agreed to abide by the tenets of the SEC Practice Section. One of the guidelines established by the Practice Section is the requirement of a concurring partner review on all SEC engagements.

^{8/} Kahler's securities are registered under Section 12(b) of the Securities Exchange Act of 1934, 15 U.S.C. 781(b), requiring Kahler to file periodic reports with the Commission.

The SECPS Reference Manual sets forth guidelines for the scope and conduct of concurring partner review. Exs. 167, 243. And Potts is bound by a number of regulations that require that he assure that audits and financial statements in which he concurs comply with GAAS and GAAP.

All certified public accountants engaged in audits of public companies must adhere to GAAP, GAAS and Regulation S-X. Potts like all members of the AICPA must follow the ethics rulings of the AICPA. AICPA ET 202, 203; Tr. 636-38, 653, 655-56. Potts signed documents with regard to both audits indicating he had reviewed the financial statements and audits and concluded that they satisfied the standards of the profession. His failure to insure that they did constitutes improper professional conduct and violates Rule 2(e). In re Checkosky and Aldrich, 52 SEC Docket 1389 (Aug. 26, 1992), appeal pending, Checkosky v. SEC, Nos. 92-5158, 92-1396 and 92-1214 (D.C. Cir.).

Kahler did not accurately account for the University Park Hotel on its financial statements in 1988 and 1989. All of the accounting experts who testified in this proceeding agreed that the UPH was a material accounting issue. Kahler reported to the Commission in its annual report for the fiscal year 1988 that "a property acquired in 1987" was being held for sale at a value of \$16,532,000. The losses of \$1,347,000 associated with the property were excluded from the statement of operations and capitalized. The effect was material on the financial statements. If the losses had been included in the operating statement, the net loss for 1988

would have been \$2,808,000 instead of the \$1,842,000 loss reported.

Kahler accounted for UPH in this manner because it ostensibly intended to sell the hotel. The record does not support such a treatment. APB Opinion No. 30 specifies the accounting and reporting for disposal of a segment of a business and the disclosure requirements. EITF 85-36 is a consensus position of the EITF regarding the application of APB 30 to a portion of a segment. In order to have excluded the losses on the income statement, management was required to commit to a formal plan to dispose of the segment whether by sale or abandonment. The plan needed to identify the asset to be disposed of, the method of disposal, the period expected for completion of the disposal from the date that the formal plan was established, and Kahler was required to initiate an active program to find a buyer, provide an estimate of the results of operations of the segment from the measurement date to the disposal date, and estimate the proceeds to be realized from the disposal. A determination by management had to be made at the measurement date of whether a gain or loss would result from disposal based on estimates at that date of the net realizable value of the segment after giving consideration to costs and expenses directly associated with disposal and estimated income or losses from operations from the measurement date to disposal. Finally if the period of disposal is revised to a period of time longer than one year, the net realizable value of the segment must be revised and the revision treated as a change in estimate.

In addition, the notes to the financial statements for the period encompassing the measurement date and subsequent periods should identify the segment, expected date of disposal, expected manner of disposal, description of the remaining assets and liabilities of the segment and the income or loss from operations from the measurement date, as compared with prior estimates.

Potts does not seriously contend that APB Opinion No. 30 was complied with by Kahler, or that it need not have been. No witness appeared in this proceeding and urged that the accounting for the UPH was in compliance with GAAP or GAAS. In fact, neither Gregory Melsen, the engagement partner, nor Kahler and various Kahler management officials, all of whom were the subject of orders of the Commission in this matter and had proceedings instituted against them based on their conduct, have chosen to contest that finding.

Potts' argument centers on his obligations as concurring partner in the audits. He claims that he was not responsible for finding and correcting material accounting errors that were not apparent to him when he reviewed some of the documents in the Top File and the financial statements and related documents. It also appears to be his contention that insofar as he knew about the materiality of the UPH to Kahler's financial statements and the issues presented by not including the losses in the income statement, he believed that the auditors on the engagement team had satisfied all accounting requirements. Neither the record nor the law supports his position.

Potts' role was not nearly as slight as he claims. He billed over 45 hours for work on the Kahler audits. Despite innumerable red flags he failed to insure that the audit and financial statements and related filings made to the Commission were in compliance with GAAS and GAAP. At the outset, Touche's risk assessment of the Kahler audit was that Kahler's president, Harold Milner, took an "unduly aggressive" approach to financial reporting. Moreover, according to the Touche auditors, Kahler's management level accounting and financial personnel "lacked the backbone or persuasive ability to check Milner's aggressive accounting policies." Melsen, Touche's engagement partner on the Kahler audits, observed in a memo that discussions with Milner were "challenging particularly related to significant transactions or the application of certain accounting principles and auditing standards." These assessments were available in Touche's Top File which Potts consulted in his concurring partner review.

There were any number of red flags that should have alerted Potts to the UPH issues. Potts first learned that Kahler was interested in treating the UPH as a discontinued segment at a luncheon with Kahler's president and treasurer and the Touche engagement partner, Gregory Melsen, in March of 1988. In a memo to Kahler's board after the meeting, Harold Milner, Kahler's president, told the board that Touche had said that if Kahler had a reasonable plan for selling UPH, it could book the hotel as an asset held for sale rather than as a depreciable asset.

Potts denied at the hearing that the Milner memo reflected what was discussed at the luncheon. But his disclaimer is contrary to his testimony during the investigation, when he said that time was spent talking about how Kahler would account for the proposed sale of the UPH. He represented that he discussed the need for a formal plan, disposition of the property, the need to be aware of the net realizable value and to insure that the value of the assets on the books was realizable. Potts testimony at the hearing that the discussion was brief and without details is not credible. Potts initial testimony that the details were discussed came at a time nearer to the matters at issue and also was testimony provided by Potts before he knew he would be held accountable for his role in the audit.

Donald Moulin was a concurring partner on between 10 to 20 audits involving ABP 30 at KMPG Peat Marwick. He concluded that the knowledge that Potts derived from the March 1988 luncheon should have alerted him that he needed to take action to ensure that accounting treatment for the hotel was proper. Moulin said that if Potts had acted reasonably, he would have instructed Melsen to be sure the client had formulated a formal plan and prepared auditable estimates of the results of the disposition of the hotel. Melsen should have in turn memorialized his actions in a memo for the Top File which Potts could have reviewed as concurring partner.

The April 1988 minutes of Kahler's board indicate that their intention was to sell only an interest in the hotel and those minutes were in Touche's 1988 Top File. Potts said he normally read

the minutes and that the April minutes were familiar to him. Although the Board did not authorize the sale of an interest on the UPH until mid-April 1988, Kahler treated the UPH as an asset held for sale from the beginning of FY 1988. Both actions were apparent to anyone reviewing the audit and both actions appeared from the documents in the Top File to be inconsistent with APB 30.

The September Kahler board minutes were also in Touche's 1988 Top File. Those minutes too indicated that Kahler intended to find a purchaser who would only share in the ownership of the UPH. Potts said that he might have seen these minutes also. But he took no action during his review to insure compliance with APB 30.

Kahler formulated at least 12 investment proposals over the course of two years seeking investors to participate in the ownership of the hotel. One of these involved the Minneapolis investment banking firm of Piper, Jaffray & Hopwood. The firm was asked to sell a 50 percent interest in the investment partnership whose interests consisted of the UPH and the Clinic View Inn. Potts testified that he was aware of Kahler's arrangement with Piper Jaffray to sell a 50 percent interest and that he was concerned about the implications of the arrangement on the accounting treatment of the hotel. But he never acted on his concern. He never contacted or directed a member of the engagement team to contact Kari Brenna, the Piper Jaffray vice president who was trying to sell the interest in UPH, to determine if she was trying to market a 100 percent interest in the hotel.

Potts told the Commission's investigators that a formal plan existed when "the company's intent was laid out and documented as attested to by the Board and others." He admits that the only evidence he saw was the Board's authorization of the sale of part of an interest in the UPH partnership. Tom Binting, Touche's national director of auditing services, testified that the April minutes needed additional discussion in order to constitute a formal plan. Binting said those minutes should have raised two questions for Potts. He should have asked about what exactly was being sold and if the April minutes were the authorization to treat the hotel as a discontinued segment, why the losses were being deferred for the entire year and not just the last three quarters. In fact, Potts knew about the later problem and discussed it with Melsen. They agreed that the authorization was sometime near the end of the first quarter. Given this knowledge Potts acted improperly.

Potts never asked to see the formal plan for the disposition of UPH. Potts stated that when he conducted his end of the year review, Melsen told him he had uncovered evidence that questioned the commitment of Kahler management to dispose of their equity interest in the hotel. Potts said that the evidence was the Piper, Jaffray engagement letter and an investment proposal packaging the UPH with another hotel property. While Potts had seen the Piper, Jaffray letter, he did not ask to see the other contradictory evidence or ask the engagement partner for more details, he said.

Potts admits that, if he had, it would have required further examination of the accounting issues.

During the investigation, Potts was asked if he ever saw any of the dozen investment proposals for UPH. He said that he had and that he had seen them prior to a meeting in early 1989. But at the hearing he said the only evidence he saw was the Piper, Jaffray engagement letter and that he saw no proposals in 1988.

Potts also failed to check on whether management had determined the net realizable value or had an appraisal of the UPH in order to estimate the gain or loss to be realized on the disposition of the hotel. The 1988 audit work papers do not contain that information. During the investigation when Potts was asked whether he reviewed NRV analysis in connection with his review of the 1988 audit, he said that Touche had analyzed the NRV of the hotel and he remembered looking at it in part at least. He claimed then to have looked at an analysis prepared by Kevin Moug the senior Touche manager on the audit. That work paper looked at undiscounted cash flow over a 40 year period and compared the costs of constructing the UPH with the Kahler Plaza hotel in Rochester, Minnesota. However, when shown the same work paper at the hearing, Potts said he had not seen it. The testimony of the expert witnesses was unanimous that Moug's work paper did not establish net realizable value. The record shows that Potts failed to ensure that reliable evidence supported this critical audit issue. Touche's national director of auditing services, Bintinger, stated that the auditing team should have assembled evidence supporting

the accounting treatment of the UPH and that it was Potts' job as concurring partner to challenge that evidence.

APB 30 requires property held for sale be identified in a footnote to the financial statements. The UPH was not directly identified as the property held for sale in the financial statements. Potts said that it was fairly obvious from the description provided. The footnote only indicated that it was a property in its first full year of operation. Potts said that this was adequate identification because in another place in the report the UPH was described as having been purchased in 1987. Milner gave a more credible explanation of what was intended. He said that the information was deliberately obfuscated in order that competitors would not identify the hotel. AU § 431.03 provides that if management omits from the financial statements, including the notes, information that is required by GAAP, the auditor should express a qualified or adverse opinion. Potts did not cause that to happen.

All of the accounting experts, who appeared for the OCA, testified that Potts' failure to act as a reasonable concurring partner contributed to the fact that the 1988 audit was not performed in accordance with GAAS.

The Commission began an informal investigation into the accounting treatment accorded UPH in July or August 1989. A document request was made to Touche which included correspondence in Potts' files concerning the UPH. On the last day of fiscal year 1989, Kahler brought the UPH back on its books as an operating

property and distributed the book value of the hotel in various items under Property and Equipment. However, Kahler deferred the depreciation for the entire year. The amount of the losses were not shown on the income statement nor were they disclosed in the footnotes. This violated the requirements of ABP 30. Melsen consulted with Touche's national office about the 1989 footnote disclosures but Potts did not participate although he knew the consultation was going on.9/

The evidence indicates that the accounting treatment accorded the UPH in Kahler's 1989 financial statements was inappropriate and the financial statements were not presented in conformity with GAAP and the 1989 Touche audit performed in accordance with GAAS. Potts signed the concurring partner checklist indicating that he had concluded that the financial statements were in conformity with GAAP and the Touche report in accordance with GAAS.

Potts knew that the SEC was investigating issues relating to the UPH's treatment as an asset held for sale but he did not initiate a reexamination of the 1988 financial statements, he did not involve himself in the research and consulting stream regarding the UPH in the 1989 audit.

It was apparent from the evidence that was available to Potts that the valuation of hotel did not meet the requirements of

9/ Another concurring partner at Touche acted differently. Robert Hyde, Director of Professional Standards Review for Touche's Twin Cities office, acted as concurring partner when Kahler filed a Form S-2 with the Commission. In the course of his review he was a part of the research and consultation stream as provided in the Touche policy.

APB 30. He did nothing to correct the errors. When the auditors sought independent valuation advice from Kenneth Riggs in Touche's Chicago valuation office, they altered the information he provided with that submitted by Kahler management. Even though it was apparent that the information supplied by Kahler was very aggressive and not based on historical results (for example, the auditors relied on Kahler's projections of discounted cash flow and altered those used by Riggs even though the actual results for the hotel were three and four time less favorable than Kahler's projections), Potts did not question the changes made over the analysis provided by Riggs. The record does not reflect that Potts questioned Melsen about why he did not follow Riggs' advice.

On the other hand, Potts argues that he relied on the Touche's national office for insuring that the footnotes adequately disclosed the accounting treatment of the UPH. The record reflects that Touche's national office did not have all the audit evidence and facts relevant to the accounting treatment of the UPH. Nor did those who Melsen consulted at Touche's national office read the entire financial statements or annual report. Instead of using net realizable value to analyze whether the operating losses could be deferred, the footnotes used the estimated recoverable value. Kahler included the revenues generated by the UPH in its total revenue figures but it did not reflect the losses in the income statement.

All of the experts who testified for the OCA were in agreement that Potts should have corrected the accounting treatment being

applied to the UPH and failed to do so. It was their conclusion that his conduct was more than just careless, it was reckless and unreasonable.

Potts Is Legally Liable for His Actions

Potts argues in this proceeding and his motion to dismiss that because there are no specific agency rules to govern the role of the concurring partner, Rule 2(e) is too vague for him to have known what actions he was expected to take as a concurring partner. He argues that it is not enough that Touche, the AICPA and state regulators have set standards for a concurring review partner by which he was bound. Before the Commission may hold him accountable for his unreasonable conduct, he maintains, the Commission is required to have its own specific rules delineating what it expects of a concurring review partner. He also argues that the Commission does not have the authority to discipline accountants that practice before it and that, in any event, his actions had to be intentional before he could be disciplined. These arguments lack merit when applied to Potts.

This proceeding was conducted pursuant to Rule of Practice 2(e). The underlying rationale for Rule 2(e) has been affirmed without judicial dissent. Davy v. SEC, 792 F. 2d 1418 (9th Cir. 1986); Touche Ross & Co. v. SEC, 609 R.2d 570 (2d Cir. 1979); see SEC v. Csapo, 533 F.2d 7, 12 (D.C. Cir. 1976). Potts has not raised any arguments regarding the Constitutionality of Rule 2(e) which were not considered previously by the Commission and rejected. The facts of this proceeding do not indicate that

procedural fairness was violated or that Potts did not know that as an accountant undertaking SEC practice work, he would be held responsible for compliance with the ethical standards that apply to certified public accountants.

His next claim is that the Commission was required to set specific standards for concurring partners in order to hold him accountable for his unethical conduct. The standards applied in this decision to Potts' behavior are those which are imposed on all accountants when they practice before the Commission or hold themselves out to be CPA's. The test is not whether the Commission has promulgated rules, because the Commission is not restricted in carrying out its regulatory duties to cases which are governed by rule, but whether the standards applied by the Commission to Potts are consistent with the statute and Commission policy. American Power Co. v. SEC, 329 U.S. 90, 106 (1946). Potts is expected by the Commission to adhere to generally accepted professional standards.^{10/} Potts knew what was expected of him. Rule 2(e) (1) (ii) of the Commission's rules of practice notifies people who

^{10/} Potts points to Securities and Exchange Commission v Pros International, Inc., 994 F. 2d 767 (10th Cir. 1993) where the Commission sought injunctive relief against an accountant, who it was alleged, violated §10(b) of the Exchange Act and Rule 10b-5 thereunder. The court does not discuss the issue presented here whether an accountant who practices before the Commission can be suspended from practice before the Commission for engaging in unethical or improper professional conduct. In Pros International the Commission sought to establish that the defendant's accounting representations were part of a scheme to defraud investors. There is no claim here that Kahler's accounting statements were in violation of §10(b) or Rule 10b-5, or even if they were, that Potts aided and abetted that scheme.

appear before the Commission that the Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way if the person has "engaged in unethical or improper professional conduct." There is "[n]o unfairness whatsoever in holding those professionals who practice before [the Commission] to generally recognized norms of professional conduct, whether or not such norms had previously been explicitly adopted or endorsed by the Commission. To do so upsets no justifiable expectations, since the professional is already subject to those norms." William R. Carter, 47 S.E.C. 471, 508 (1981).

The accounting experts who testified were unanimous that a reasonable concurring partner would not have acted as Potts did in conducting his review of the Kahler audit and financial statements. Potts was only expected to know what constitutes unprofessional conduct in his profession. Potts has practiced before the Commission for over 15 years. He was a senior partner of long standing in one of the six largest accounting firms in the country.

His job was to provide additional assurance that the financial statements were presented in conformity with generally accepted accounting principles and that the Touche reports were prepared in accordance with GAAS. Ex. 167. At the conclusion of the 1988 and 1989 Kahler audits, Potts signed documents indicating that he had reviewed the financial statements at issue and the audits thereon, and concluded that they satisfied the standards of the profession.

As set forth in Codification of Statement on Auditing standards, AICPA AU § 110.09 (1989): "The independent auditor also has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners." Concurring partners are not exempted. The Minnesota Code of Professional Conduct for accountants requires all CPA's to comply with GAAS and GAAP. See Minn. R. 1100.4800 and 1100.4900 (1987) reprinted in Accountancy Law Rep. (CCH) ¶ 25,714 at 6053.11/

The Order initiating this proceeding states that the OCA has alleged that Potts, in performing his professional services in connection with the rendering of an audit opinion on the 1988 and 1989 Kahler audits, deviated from the accepted professional standards by (1) failing to exercise due professional care (AICPA AU § 230); (2) failing to obtain sufficient competent evidential matter to support the opinion as required by the third general standard of field work (AICPA AU §§ 326 and 339); (3) misapplying

11/ On February 14, 1994, Potts moved to receive into evidence the minutes of a meeting, "SEC Regulations Committee Meeting/Joint Meeting with SEC Staff/September 16, 1993" and on March 2, 1994, almost five months since the close of the hearing, Potts moved to take the deposition of Walter P. Schuetze, Chief Accountant of the Commission. Schuetze apparently said at that meeting that "existing standards for concurring partner reviews should be further developed, enhanced, and strengthened." Potts believes that Schuetze's statement demonstrates the validity of his claim that there are no standards for his performance and that he, therefore, cannot be held accountable by the Commission for his actions as an accounting professional. Nothing on the face of the quoted passage lends support to that claim. In any event, the order instituting this proceeding is the Commission's statement on the law applicable to this case even if Schuetze's comments were in conflict with the Commission's views. Potts' motions are denied.

generally accepted accounting principles (AICPA AU §§ 410 and 411); and (4) consenting to an opinion stating that the audits were conducted in accordance with GAAS when they were not (AICPA AU § 508.14 and ET 203). The record as a whole supports those allegations.

Potts also argues that scienter should be weighed in deciding whether he should be suspended from practice before the Commission. The Commission recently considered all the arguments presented by Potts in David J. Checkosky, 52 SEC Docket 1389, 1409-1411 (1992). There, the Commission stated that it had routinely rejected arguments for limiting Rule 2(e) proceedings against accountants to those where scienter is present because accountants, unlike attorneys, have a duty to the public that rely on the reports and they publicly represent that the code of conduct embodied in the statements of the auditing standards promulgated by the AICPA has been followed. Citing, Carter, 47 S.E.C. 471 (1981). The Commission has rejected the standard urged by Potts because an incompetent or negligent auditor can do just as much harm to public investors and others who rely on him as someone who acts with improper motive. Id. But even assuming the standard were more lenient, the evidence shows that Potts was reckless. He ignored or overlooked numerous red flags, he did not question management's representations, he failed to exhibit the requisite degree of care

and inquiry that was demanded under the circumstances and his testimony about his actions was not reliable.^{12/}

Similarly, Potts argues that he acted in good faith in following Touche procedures and relying on Melson and the Touche National Office. According to Potts, his alleged good faith should absolve him of culpability. As indicated above, Potts was reckless in ignoring or overlooking red flags that should have indicated to him that, at a minimum, further inquiry was required. Such a finding is inconsistent with good faith. But even if there was some indication that Potts acted in good faith, it is irrelevant to the issue to be determined in this case. On the other hand, if Potts had merely made an error of judgment or had been careless, it is unlikely that the Commission would have considered him an appropriate subject for professional discipline. But such is not the case.

Finally, Potts asserts that the Commission has not sanctioned a concurring partner for improper professional conduct under Rule 2(e) in 20 years and therefore this proceeding against him should be dismissed. In support of this position, Potts cites Lester Witte & Co. where the Commission criticized the conduct of a concurring partner but did not sanction him. 47 S.E.C. 409 (1981).

^{12/} Potts also argues that the proceeding was defective because the rooms used for the hearing could only be entered after gaining permission to enter the building. Whatever the legal merit of such an argument, there is no factual basis for it. There is no evidence that anyone was prevented from attending the hearing and the presiding officer observed that witnesses and persons not associated with the Commission attended the hearing.

Potts misconstrues the import of that decision. There, the Commission found that the inadequacy of the concurring partner's review was due in part to the inadequacy of the accounting firm's concurring partner review program. No such allegation has been advanced in this case. The clear import of the Commission's decision in Lester Witte is the opposite of Potts' understanding: concurring review partners must follow all professional and firm guidelines to avoid charges of improper professional conduct under Rule 2(e).

Potts also is incorrect in asserting that the Commission has not sanctioned concurring partners in the last 20 years. The Commission in Stephen Kutz, 37 SEC Docket 971 (Jan. 28, 1987), temporarily denied the privilege of appearing or practicing before it to a concurring partner it found had engaged in improper professional conduct. The Commission noted in Kutz that the activities of the concurring partner in the audits at issue exceeded those usually associated with concurring partners because it included planning and performing audit work. Nonetheless, the Commission sanctioned the concurring partner for authorizing issuance of unqualified opinions "when he knew, or should have known, that [the auditors] had not conducted the respective audits in accordance with GAAS." 37 SEC Docket at 982. In this respect, Potts' conduct is very similar to the conduct at issue in Kutz.

The Hearing Evidence Warrants a Sanction in this Case

The preponderance of the evidence establishes that Potts engaged in improper professional conduct in violation of Rule 2(e).

The evidence in this record demonstrates that this is a case in which a sanction will protect the investing public and the Commission from the future impact of professional misconduct on its processes. Potts had numerous warning signs to alert him that the audit of Kahler was not being properly conducted and that the financial statements were inconsistent with acceptable accounting principles. His testimony at the hearing was not credible on critical points. Moreover, this is not the first time that Potts has been involved with an audit criticized by the Commission. His conduct as concurring partner on the 1988 and 1989 Kahler audits amounted to recklessness.

Potts is not currently engaged in public accounting but he has spent his entire career working as a certified public accountant at Touche. As things now stand he could return to practice before the Commission at any time. For this reason, the investing public and the Commission should be protected against that possibility. OCA has urged that Potts be censured and suspended from practicing or appearing before the Commission for a period of 18 months. This is less of a sanction than the concurring review partner in In re Kutz, 37 SEC Docket 971 (January 28, 1994). Kutz failed to insure that the audits complied with GAAS and that the financial statements were presented in accordance with GAAP. The Commission denied Kutz the privilege of appearing or practicing before it as an accountant for two years. Kutz was also required to attend professional seminars or college courses for 60 hours. The second partner in In re Stephen O. Wade, et al., 30 SEC Docket 1195 (June

25, 1984) was prohibited for three years from direct or indirect involvement in any audit engagement of any entity or company whose financial statements are reasonably expected to be filed with the Commission.

Wade failed to exhibit healthy skepticism and improperly interpreted certain relevant accounting principles.

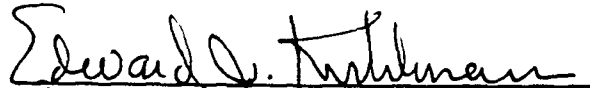
While Potts has argued that he should not be sanctioned, he has not shown that the 18 months proposed by OCA is unreasonable in light of past sanctions imposed on accountants who violated Rule 2(e). A suspension of eighteen months will ensure protection of the investing public and of the Commission's processes.

Accordingly, it is ordered, pursuant to Rule of Practice 2 (e) (1), 17 C.F.R. § 201.2 (e) (1), that William D. Potts is suspended from appearing and practicing before the Commission for a period of 18 months.

IT IS FURTHER ORDERED, that the motion to dismiss filed July 21, 1993 by Robert D. Potts and remanded for consideration in this decision on January 21, 1994 IS DENIED.

Pursuant to Rule 17(f) of the Rules of Practice, this initial decision will become the final decision of the Commission as to any party who has not, within fifteen days after service of this initial decision, filed a petition for review pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review the decision. If the respondent

timely files a petition for review, or the Commission takes action to review, the initial decision will not become final. 13/


Edward J. Kuhlmann
Administrative Law Judge

Washington, D.C.
May ~~18~~, 1994
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13/ The respondent raises various other arguments which have been considered and rejected. All proposed findings and conclusions submitted by the parties have been considered, as have their arguments. To the extent such proposals and contentions are consistent with this initial decision, they are accepted. In all cases where applicable, the demeanor of the witnesses has been considered in assessing their testimony. The conclusions reached are based upon a preponderance of the evidence.