UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61162 / December 14, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3080 / December 14, 2009

Admin. Proc. File No. 3-12208

In the Matter of

KEVIN HALL, CPA
and
ROSEMARY MEYER, CPA

OPINION OF THE COMMISSION

RULE 102(e) PROCEEDING

Grounds for Remedial Action

Improper Professional Conduct

Certified public accountants acting as engagement partner and senior manager were charged with having engaged in improper professional conduct in both the audit and the interim review of a public company's financial statements. *Held*, the matter is *dismissed*.

APPEARANCES:

Miles N. Ruthberg, Peter W. Devereaux, Jamie L. Wine, William R. Baker, III, David A. Becker, and *Kevin H. Metz*, for Kevin M. Hall.

Gary F. Bendinger, Wesley D. Felix, and *Yolanda Hawkins-Bautista*, for Rosemary K. Meyer.

John D. Worland, Jr., Robert W. Pommer III, H. Michael Semler, and *Matthew B. Greiner*, for the Division of Enforcement.

Appeal filed: February 6, 2008
Last brief received: May 21, 2008
Oral argument: July 21, 2009

The Division of Enforcement appeals from the decision of an administrative law judge in a proceeding brought pursuant to Commission Rule of Practice 102(e) ("Rule 102(e)").[1] The law judge found that the conduct of Kevin Hall, CPA and Rosemary Meyer, CPA (together, "Respondents"), in connection with the fiscal year ("FY") 1999 audit of the financial statements of U.S. Foodservice, Inc. ("USF") and the interim review of USF's second quarter FY 2000 financial statements, was not improper under the Rule. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

I.

The Audit of the Fiscal Year 1999 Financial Statements

A. Background

USF is a food service and distribution company. The accounting firm KPMG, LLP ("KPMG") served as USF's independent auditor for fiscal years 1997, 1998, and 1999.[2] Respondents worked on KPMG's audits of USF's financial statements for all three audits.[3]

Hall was the engagement partner, and Meyer was the senior manager, on the audit of USF's FY 1999 financial statements. Hall signed an unqualified audit opinion stating that KPMG had conducted its audit in accordance with generally accepted auditing standards ("GAAS") and that such audit provided a reasonable basis for its opinion that USF's FY 1999 financial statements fairly presented USF's financial position, the results of its operations, and its

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[1] 17 C.F.R. § 201.102(e). With the passage of Section 602 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 794 (2002), this rule was codified in Section 4C of the Securities Exchange Act of 1934, 15 U.S.C. § 78d-3.

[2] During the periods audited by KPMG, USF's fiscal year ended on the Saturday closest to June 30.

[3] Respondents also worked on KPMG's interim review of USF's quarterly financial statements for the second quarter of FY 2000. *See infra* Section III.

cash flows, in conformity with generally accepted accounting principles ("GAAP").[4] It is undisputed that USF's financial statements for FY 1999 do not accord with GAAP.

B. Details of USF's Accounting Fraud

At the time of the FY 1999 audit, USF purchased products from approximately 7,000 vendors and re-sold them to customers such as restaurants, hospitals, and schools. Many of the purchases were made through brokers, many of whom handled multiple vendors.

USF received rebates called promotional allowances ("PAs") from national vendors responsible for the largest volume of USF's purchases. The payment of PAs is a common practice in the food distribution industry that is not itself improper. Most PAs were volume discounts, treated on USF's income statement as a reduction in the cost of sales. On USF's balance sheet, collected PA income increased USF's cash, and uncollected PA income was included in accounts receivable. PA income was extremely important to USF's profitability; it roughly equated to USF's net income.

The Division introduced evidence, and Respondents do not dispute, that during the time at issue, USF was engaged in an earnings management fraud based in part on its accounting for PAs.[5] The scheme involved prepayments of PA income to USF that were improperly booked as income when received although they had not yet been earned, and intentional overpayments by USF to brokers who "sheltered" the excess funds until USF needed them to make up for shortfalls in PA income.[6]

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[4] GAAS are generally described in the American Institute of Certified Public Accountants ("AICPA") Codification of Statements of Accounting Standards, hereinafter cited as "AU § __." Section 103 of the Sarbanes-Oxley Act, 15 U.S.C. § 7213, conferred the power to establish auditing standards and rules for public companies on the Public Company Accounting Oversight Board ("PCAOB").

[5] The ensuing description of the fraudulent conduct at USF is based largely on the testimony of Timothy Lee, who admits to having participated in the fraud. *See infra*. Although liability for the fraud is not at issue in this proceeding, and we make no findings regarding such liability, we provide information about the fraud as a context for our findings about Respondents' conduct. Our findings with respect to any persons other than Respondents are made solely for the purpose of this proceeding.

[6] The accounting fraud continued to grow in scope. USF was acquired by Koninklijke Ahold N.V. ("Royal Ahold") in April 2000, and a new auditor was retained. The fraud only came to light in early 2003, at which time Royal Ahold conducted an internal investigation. Forensic accounting revealed overstatements of pre-tax earnings at USF of

(continued...)

Mark Kaiser, USF's senior vice president, then executive vice president of sales and marketing, and Timothy Lee, executive vice president of USF's purchasing group, orchestrated the accounting fraud. Kaiser initiated the PA prepayment scheme in the mid-1990s. At his direction, USF negotiated deals with some of its largest vendors whereby USF would commit to purchasing a certain amount of product and the vendor would commit to paying USF a stated allowance before the purchases had been completed. Some prepayments were to be made directly by the vendor; others were to be made through a broker who worked with the vendor. Agreements with some vendors allowed the vendor to obtain a refund of the prepayments if USF did not purchase the agreed-upon amounts.

Kaiser instructed Lee to keep the prepayments concealed from everyone outside the purchasing group. For example, Kaiser told Lee to prepare summaries of the vendor purchasing arrangements that omitted the prepayment provisions; if USF's auditors asked to see the contracts, they were given only the summaries.

USF had grown primarily through corporate acquisitions, and its purchasing data resided on computers that did not share a common operating system. For that reason, USF's purchasing group relied on its vendors to calculate and report PAs due to USF. Once a month, the purchasing group calculated how much PA revenue should be recorded and instructed USF's accounting group to book the revenue in USF's general ledger, the main source consulted in the preparation of USF's financial statements. The purchasing group also provided the accounting group with adjustments, representing increases in PA income, at the end of each quarter.

USF's PA account comprised accrued unbilled earnings and outstanding billed receivables. USF recognized all the income from each prepayment upon receipt. Under GAAP, USF should have recorded the prepayments as liabilities, because they were not yet earned. USF would not have met analysts' consensus earnings expectations without these adjustments, but with them USF met or exceeded these expectations every quarter in fiscal years 1998 and 1999.

Kaiser also arranged for income to be sheltered by various entities to satisfy PA balances due. For example, in December 1998 and June 1999, he directed Lee to make lists of outstanding PA billings and to send them to Gordon Redgate, owner of Private Brands. Private Brands was a broker that dealt in canned goods and groceries. Kaiser had arranged to overpay Private Brands for certain goods, and Redgate was holding this excess payment as shelter income for USF.[7] Kaiser, through Lee, instructed Redgate to issue checks returning some of the shelter income that would retire the balances of vendors on the lists, even though Private Brands had no relationship with some of those vendors. Redgate arranged for the checks to be issued as

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[6] (...continued)
approximately $880 million between April 1, 2000 and December 28, 2002. *See* Royal Ahold's Form 6-K dated May 8, 2003.

[7] This overpayment resulted in an overstatement of the cost of goods to USF, and thus a separate GAAP violation.

requested. The checks were treated by USF as PA payments on behalf of the vendors, and, like legitimate PA payments, they were recorded as income.[8]

C. KPMG's Audit of USF's 1999 Financial Statements

Hall's responsibilities as engagement partner for the 1999 audit included planning the engagement, assigning tasks to and supervising the staff, and ultimately drawing the conclusion with respect to the financial statements taken as a whole. Meyer helped Hall plan the audit; she also had responsibilities for supervision, review of workpapers, evaluation of audit evidence, and informing Hall about the progress of the audit and about issues of concern. Seven or eight additional KPMG staff members also worked on the 1999 audit.

Respondents' planning and execution of the FY 1999 audit was informed by their work on previous USF audits. Hall testified that he had found management's representations in connection with those audits correct, giving him confidence in management's integrity. Additionally, USF required its senior management to sign questionnaires asserting their compliance with a code of conduct, a measure Hall regarded as uncommon at that time.[9] Meyer also stated that she had a positive impression of USF management.

Management told Respondents during prior audits that USF did not have formal executed written contracts with its vendors. Respondents asked about the possibility of prepayments of PA income and were told, "There were no prepayments of any amounts that had not been earned, period." A management representation letter signed by five members of USF senior management

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[8] The U.S. Department of Justice brought criminal charges against Kaiser and Lee. Based on his wrongdoing at USF, Kaiser was convicted of one count of securities fraud, four counts of false filing with the Commission, and one count of conspiracy. *United States v. Kaiser*, 1:04-cr-00733-TPG (S.D.N.Y. May 18, 2007). He was sentenced to seven years of imprisonment and two years of supervised release, and fined. *Id.* Kaiser has filed an appeal of his conviction, which remains pending. *United States v. Kaiser*, 07-2365-cr (2d Cir. filed June 4, 2007). Lee pleaded guilty to four felony charges of securities fraud, conspiracy, and making materially false and fraudulent statements to the United States government. *United States v. Lee*, 1:04-cr-00712-PKC (S.D.N.Y. July 27, 2004). We brought multiple civil actions and administrative proceedings related to the fraud at USF. *See SEC Charges Thirteen Individuals with Aiding and Abetting Fraud at U.S. Foodservice*, Litigation Rel. No. 19975 (Jan. 22, 2007), 89 SEC Docket 2929 (noting that nine out of thirteen individuals charged with aiding and abetting fraud agreed to settle enforcement actions and listing eight related actions brought by the Commission).

[9] Under a rule promulgated by the Commission in 2003 pursuant to Section 406(a) of the Sarbanes-Oxley Act, 15 U.S.C. § 7264(a), companies required by the Exchange Act to file annual reports on Form 10-K must disclose whether they have adopted a code of ethics for certain senior officers, and if not, why not. 17 C.F.R. § 229.406(a).

during an earlier audit stated that USF received no prepayments of PA income. USF's accounting for PA income was consistent with these management representations. Thus, any evidence the auditors uncovered suggesting that there were prepayments should have raised serious issues concerning not only the correct accounting for PAs, but also the integrity of USF's senior management.

KPMG viewed the PA account as posing a high inherent risk, because individual balances were significant within the account, and a high control risk, because KPMG did not intend to rely on USF's internal controls in that area. Accordingly, KPMG concluded that the risk of significant misstatement related to PAs was high for the 1999 audit, and identified as a critical audit objective determining whether "[a]ccounts receivable amounts, both billed and unbilled for vendor rebates (promotional allowances) are accurately presented, properly valued and exist." An audit planning memorandum prepared by Meyer and reviewed by Hall explained that the objective was considered critical "due to the considerable degree of management judgment relating to allowance estimates, unbilled vendor receivable estimates and revenue recognition."

Because USF's controls were unreliable, Hall selected substantive procedures to test the valuation, existence, and completeness of the PAs. Two of these procedures, vouching cash receipts and confirming vendor receivables, are at issue in this appeal.

1. Vouching Cash Receipts

Respondents planned their cash receipts testing procedures to obtain information about cash collection trends and about USF's application of incoming cash to appropriate accounting periods. For their principal cash receipts testing procedure, Respondents selected approximately thirty-five vendors from the billed aged trial balance as of the end of USF's FY 1998 and tracked their account balances during the subsequent fiscal year. From a subset of twenty of those vendors, Respondents sought remittances in amounts greater than $100,000 for detailed cash receipts testwork and obtained a set of fifty checks and one wire transfer, eight of which exceeded one million dollars. Respondents were unable to analyze six of the fifty-one items, identified as the "Discrepancies," satisfactorily on the basis of the information they had. Four of these Discrepancies were among the eight items that exceeded one million dollars.

Three of the Discrepancies raised the possibility of prepayments on PA programs. A $1.8 million wire transfer from Nabisco identified $1.2 million of the payment as an "Advance on USF baked goods agreement," the remittance accompanying a Tyson check for approximately $1.3 million read "99 m/1 prepay," and the remittance accompanying a $240,000 check from Dakota Growers Pasta ("Dakota") read "Final 5year contrt pymnt."[10] Respondents gave USF

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[10] The remaining Discrepancies -- a Dakota check for approximately $124,000, a Seafood Marketing Specialists check for $450,000, and a four million dollar check from Superior (continued...)

management a PA Discussion Points Memorandum that identified, among other things, these apparent prepayment issues for further discussion with management. Management's renewed reassurances that USF did not receive prepayments or advances of PA income did not resolve Respondents' concerns, and in early August, USF agreed to help Respondents obtain additional third-party documentation.

The record includes almost no documentary evidence showing how Respondents resolved the Discrepancies. One workpaper, captioned "Promotional Allowance Receivables," states that Kaiser "obtained confirmation from the vendors that [the] cash receipts [involved in the Discrepancies] . . . **were not** prepayment on fiscal 1999 programs or other advances" (emphasis in original). The workpaper continues, "See D-32 series for documentation of resolution." The record does not contain a workpaper series denominated D-32 nor does it establish what happened to it or even whether it was ever created.[11] Meyer testified that she intended for the third-party documentation clearing the Discrepancies to be put in the workpapers, although whether in D-32 or elsewhere she could not remember.

The record contains two letters Respondents contend are illustrative of those they relied on in resolving all of the Discrepancies. A letter from Fred Paglia, Regional Vice President of Nabisco Food Service, dated December 28, 1998 (the "Nabisco letter"), reads, in relevant part:

> Congratulations on another year of outstanding performance! We are pleased to inform you that you have maxed out your 1998 Earned Income Program with Nabisco. As discussed, you will shortly be in receipt of a wire transfer of $1,196,203.
>
> Once again, thanks for a record breaking year!

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[10] (...continued)
Coffee -- raised questions about USF's applications of the payments to the proper fiscal year or other concerns; the $1.3 million Tyson check raised questions about both prepayment and application.

[11] Respondents suggested that the D-32 series, alternatively, was compiled but not properly filed with the completed workpapers, was misplaced while a successor auditor had access to the 1999 workpapers, was misplaced when the original workpapers were copied for production to the Division, or was accidentally never compiled.

A letter signed by Mike Rogers, Vice President, Western Division, Food Service Group, Tyson Food Group, and dated July 21, 1999 (the "Tyson letter"), reads, in relevant part,

> Thank you for your continued commitment and growth pertaining to our program agreements. As a result of this growth, a payout of $2,226,881 was submitted. I look forward to the future and the opportunity to max out our program.[12]

Lee testified that both of these letters used language crafted by Kaiser to be intentionally vague, susceptible of the interpretation that the payments were not prepayments, yet avoiding an explicit statement to that effect.

Meyer testified that the audit team obtained documentation that she claimed resolved the other Discrepancies, but no such documentation is in the record. Hall said that he saw the documentation. Neither Respondent provided detailed information about such purported documents.

In fact, the three checks that raised possible prepayment concerns were prepayments.[13] The checks that raised questions regarding application of funds or other concerns were all received in FY 1999 and applied, at least in part, to FY 1998 invoices; they thus reflected questionable applications of cash received.

Respondents also conducted a more limited test of subsequent cash receipts, *i.e.*, cash received after the end of FY 1999. Auditors commonly perform subsequent cash receipts testing as an alternative procedure in instances where confirmations of accounts receivable are not returned.[14] In such cases, they look to see whether particular balances are subsequently paid down by the entities that owe them.

Here, however, all the confirmation requests sent during the audit were returned, and the record is unclear as to how extensively Respondents intended to review, and did review, the application of the cash received. Meyer testified that Respondents' principal inquiry in the subsequent cash receipts testing was whether PA payments were coming in, with little attention

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[12] The record copy of the Nabisco letter was in KPMG's workpapers, but the Tyson letter was obtained from Lee. Meyer testified that, although she was not certain that she reviewed this letter, she reviewed one consistent with it.

[13] The four million dollar check from Superior Coffee was also a prepayment. *See supra* note 10.

[14] *See* AU § 330.31-32 (suggesting examination of subsequent cash receipts, "including matching such receipts with the actual items being paid," as an alternative procedure to be used in examination of accounts receivable when the auditor has not received replies to positive confirmation requests).

to how those funds were applied. Hall testified that he did not personally review the checks, and that he thought either Meyer or the audit team member who worked with her on cash receipts testing had done so. Meyer testified that, to the extent she looked at checks, she could not remember which ones she saw.

A memorandum in the audit workpapers states, "We vouched the cash receipts to check copies and vendor remittances, as applicable. . . . No problems were noted, cash was appropriately applied." These statements suggest the more detailed matching of payments to invoices that would commonly be done in subsequent cash receipts testing. However, Meyer testified that the phrase "appropriately applied" might merely mean that cash was "received." Hall testified that he was unsure about what Meyer meant by the language and was not "focused on" whether the cash was appropriately applied.

2. Confirming Vendor Receivables

Confirming vendor receivables of PA income involved sending requests to third parties asking them to confirm that certain PA income was owed and earned. Respondents employed this procedure in the FY 1998 audit of USF and expanded it in the FY 1999 audit.

Meyer obtained a list of PA accounts receivable from USF's accounting group; Hall asked USF's chief financial officer to review the list in order to obtain further assurance that the list was accurate and the amounts shown were owed and earned. Meyer selected the thirty highest balances from this list, and collaborated with Hall in choosing a representative sample of five additional balances for confirmation.

GAAS required the team to send the confirmations to persons the auditors believed to be knowledgeable about the information at issue.[15] Respondents testified that, in their experience, it was common practice to obtain contact information for confirmation requests from the audit client. Respondents understood that Kaiser would provide the contact information for the vendors and brokers. They believed that Kaiser was more familiar with and knowledgeable about the PA account than anyone else at USF. Each letter included the representation that "the invoice amount(s) is(are) due to U.S. Foodservice for rebates and/or promotional income earned on products purchased and delivered to U.S. Foodservice prior to July 3, 1999." Meyer "flipped through" the prepared letters with USF's corporate controller. Meyer testified that, in her opinion, this cursory management review of the letters provided additional assurance that the letters were addressed to appropriate people.

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[15] *See* AU §§ 330.16 (recognizing that the intended respondent of a confirmation request has a "direct effect on the reliability of the evidence obtained"), 330.27 (requiring the auditor to send the confirmation "to a respondent from whom the auditor can expect the response will provide meaningful and competent evidence").

Respondents noted that some of the letters were addressed to brokers rather than to vendors, and they noticed that some brokers were being asked to confirm balances for more than one vendor.[16] They considered these facts unexceptionable. Respondents were generally familiar with the role of brokers in USF's purchasing process from work on previous USF audits and conversations with USF management,[17] and they had seen references to many of the brokers on the list in their work on other aspects of the 1999 audit.

There were, however, gaps in Respondents' knowledge regarding the individuals and entities to whom the confirmations were sent. Respondents did not always know which brokers worked with which vendors, so they would not necessarily know whether a confirmation was being sent to an appropriate broker. Moreover, Respondents did not understand that USF did not have PA programs with vendors of commodities.[18] Respondents were therefore unlikely to realize that a confirmation of purported PA income coming from a commodities broker would be anomalous. Additionally, many of the names on the 1999 list were different from those to whom confirmations were sent in 1998. Thus, USF representations regarding addressees for the 1998 confirmations were of limited relevance.

All thirty-five letters were returned directly to the auditors with responses indicating that the information to be confirmed was correct. Respondents considered this persuasive evidence both that the addressees were knowledgeable and that the PA income in question was owed and earned in FY 1999.[19] Respondents did not know, however, that Kaiser had supplied Respondents with contact information for individuals willing to sign confirmation letters that contained false information. Some of the letters were sent to people who had no business relationship with USF. Some of the addresses used were home addresses, or addresses for entities that were not involved in the food distribution business at all.

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[16] Twenty-two of the thirty-five confirmation letters were addressed to seven people. Each of the other letters was sent to a different person.

[17] During the 1998 audit, when some of the confirmation requests were also sent to brokers, Hall had met with USF management "to confirm that, in fact, they understood who the brokers were that we were getting confirmations from." The fact that most of the letters sent in 1998 were returned, with the requested information confirmed, indicated to Respondents that the addressees were knowledgeable.

[18] Vendors typically offered PAs on sales of prepared foods. Commodities such as meat and seafood were sold at a negotiated market price, without PAs.

[19] Respondents included in the confirmations a representation that the amounts in questioned were "earned" in order to provide assurance that those amounts were not prepayments.

D. The Administrative Proceeding

The Order Instituting Proceedings ("OIP") was filed in February 2006. Largely because the administrative proceeding was stayed at the request of the Department of Justice, pending resolution of criminal proceedings arising out of the fraud, the hearing did not begin until July 2007.

The law judge found that Respondents' conduct in planning and executing both the cash receipts testing procedures and the confirmation procedures did not constitute improper professional conduct, and was, in fact, reasonable. The law judge accepted Respondents' testimony that they obtained vendor documentation clearing all six Discrepancies, although she made no explicit finding as to Respondents' credibility.

II.

Analysis of the Fiscal Year 1999 Audit

A. Applicable Professional Standards

Rule 102(e) permits the Commission to censure or deny, permanently or temporarily, the privilege of appearing or practicing before it to persons found to have engaged in improper professional conduct.[20] As relevant here, "improper professional conduct" for accountants includes "[r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."[21] The term "unreasonable" signifies an ordinary or simple negligence standard.[22] Discipline under Rule 102(e) may be appropriate when the repetition of such negligent conduct shows an accountant's lack of competence to practice before the Commission.[23] The negligence-based

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[20] Rule 102(e), 17 C.F.R. § 201.102(e).

[21] Rule 102(e)(iv)(B)(*2*), 17 C.F.R. § 201.102(e)(iv)(B)(*2*). The OIP also charged that Respondents' conduct was reckless, or highly unreasonable in circumstances warranting heightened scrutiny, either of which (if established) would also constitute improper professional conduct within the meaning of the Rule. For the reasons discussed below, we do not believe the record supports these charges.

[22] *Amendment to Rule 102(e) of the Commission's Rules of Practice*, 63 Fed. Reg. 57,164, 57,169 (Oct. 26, 1998) ("*Amendment to Rule 102(e)*").

[23] *Gregory C. Dearlove*, Securities Exchange Act Rel. No. 57244 (Jan. 31, 2008), 92 SEC Docket 1867, 1909-12 (discussing *Amendment to Rule 102(e)* and finding that Dearlove

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standards in Rule 102(e)(iv)(B) are objective, measured by the degree of the departure from professional standards rather than the intent of the accountant.[24] In applying these standards, the Commission does not evaluate actions or judgments in the light of hindsight; it focuses, instead, on what the accountant knew or should have known at the time an action was taken or a decision was made.[25]

GAAS require auditors to exercise due professional care in performing an audit and preparing a report.[26] Auditors must maintain an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence."[27] When the audit presents a risk of material misstatement or fraud, auditors must increase their professional care and skepticism.[28] Auditors must obtain sufficient competent evidential matter to afford a reasonable basis for an opinion with respect to the financial statements under review.[29] They may not substitute management representations for competent evidence, and they may not

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23 (...continued)
engaged in improper professional conduct under Rule 102(e)(B)(2)), *petition denied*, 573 F.3d 801 (D.C. Cir. July 24, 2009).

24 *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,167, 57,170. The term "applicable professional standards" "primarily refers to GAAP, GAAS, the AICPA Code of Professional Conduct and Commission regulations"; it encompasses "generally accepted standards routinely used by accountants in the preparation of statements, opinions, or other papers filed with the Commission" and "the body of professional guidance routinely used by accountants." *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,166.

25 *See Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,168 (discussing subparagraph (B)(*1*)). Respondents' conduct is judged against standards in effect at the time of the conduct at issue, although more stringent standards would now apply in some relevant areas. *See supra* note 9 (discussing 17 C.F.R. § 229.406(a)) and *infra* Section II.B.1.b. (discussing PCAOB Auditing Standard No. 3).

26 AU § 230.01.

27 AU § 230.07; *see also* AU §§ 230.08 ("[P]rofessional skepticism should be exercised throughout the audit process."), 330.15 (requiring auditors to exercise an appropriate level of professional skepticism in designing and conducting the confirmation process).

28 AU §§ 312.17, 316.27.

29 AU § 326.22.

become satisfied with less than persuasive evidence merely because they believe that management is honest.[30]

Before analyzing Respondents' conduct in connection with the two substantive procedures at issue, we address Respondents' contention that a finding of improper professional conduct within the meaning of Rule 102(e) may not be based on repeated instances of unreasonable conduct in connection with the audit of a single account -- in this case, they argue, the PA account. Rule 102(e) looks to the number of instances of unreasonable conduct, not the number of accounts. The adopting release for Rule 102(e) recognizes that "[t]he term 'repeated' may encompass as few as two separate instances of unreasonable conduct occurring within one audit."[31] There is no requirement that the two instances pertain to different accounts in that audit. The statement in the release that an auditor's failure to gather evidential material "for more than two accounts" could constitute repeated instances of unreasonable conduct[32] is merely an example of conduct that would fall under Rule 102(e)(iv)(B)(*2*). We therefore see no merit in Respondents' argument.

B. Cash Receipts Testing

1. Resolution of the Discrepancies

a. The Nabisco and Tyson Discrepancies

As discussed above, in the course of cash receipts testing Respondents identified six Discrepancies that they concluded they could not resolve without further information. The record contains two letters, purportedly written by third parties, on which Respondents relied in concluding that the Discrepancies related to the Nabisco remittance and the Tyson wire transfer were not evidence of prepayments of PAs.

Whether these two letters adequately address the concerns that led Respondents to identify the Nabisco remittance and the Tyson wire transfer as Discrepancies is a close question. Respondents knew that USF's accounting for PAs posed a significant audit risk and that any evidence of prepayments would raise critical questions about management integrity. The words "prepay" and "advance" were red flags warning of the possibility that prepayments had been made. Against this background, the resolution of these two Discrepancies assumed particular importance. The Nabisco and Tyson letters, however, do not explicitly address Respondents'

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30 AU §§ 333.02, 230.09. GAAS also requires auditors to plan the audit adequately and to supervise any assistants properly. AU §§ 311.01, 311.11. Violations of these GAAS provisions were not charged.

31 *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,169.

32 *Id.*

concerns: they do not refer to prepayments or advances at all, much less explain why the terms "prepay" and "advance" were used, if the payments at issue were not prepayments.

On the other hand, the letters appear to have been written in the ordinary course of business, predating Respondents' inquiries about the remittance and the wire transfer. Such letters would not necessarily directly address Respondents' concerns. The letters, crafted by Kaiser to be purposefully ambiguous, can be read to imply that the payments are based on past performance. The Nabisco letter congratulates USF on "another year of outstanding performance," apparently summing up the year's sales; this inference is further buttressed by the statement that USF "ha[s] maxed out your 1998 Earned Income Program with Nabisco." The statement that USF would "shortly be in receipt of a wire transfer of $1,196,203," following closely after the apparent references to the completion of an annual purchase cycle, can be read as related to that year's purchases, with the payment based on those purchases. The Tyson letter, while less clearly backward looking, is at least consistent with the theory that the payment at issue was not an advance or prepayment.

Moreover, Respondents' interpretation of the Nabisco and Tyson letters did not occur in a vacuum. Respondents confirmed balances at the end of FY 1998 in their FY 1998 audit, rolled forward the accounts to review activity during FY 1999, then confirmed balances at the end of FY 1999 in their FY 1999 audit. They knew from the workpapers of the predecessor auditors that USF had represented for years that it did not receive prepayments of PAs, and their own audit work in prior years tended to confirm that there were no prepayments. Respondents were not shown contracts with prepayment terms -- only the term sheets that omitted the prepayments. Respondents questioned management about the existence of prepayments, included a representation about the absence of prepayments in the management representation letter, and tailored the language of the confirmation letters to obtain assurances that the amounts to be confirmed were not prepayments.[33]

Given the significance to the audit of properly resolving these two Discrepancies, we do not believe that, on this record, Respondents' conduct exemplifies best audit practices. However, based on the totality of the evidence here, we cannot conclude that Respondents' conduct in resolving the Nabisco and Tyson Discrepancies constituted an instance of unreasonable conduct within the meaning of Rule 102(e).

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[33] The Division argues that Respondents admitted that the Tyson letter was too ambiguous to resolve the Discrepancy. Respondents only admitted, however, that their concerns regarding application of the Tyson payment were not adequately addressed by the Tyson letter in the record. *See supra* note 10 (recognizing that the Tyson remittance posed application as well as prepayment concerns). They assert that they obtained a second letter, which is not in the record, resolving the application concerns. *See infra* Section II.B.1.b. (discussing absence from the record of third-party documentation on which Respondents relied in resolving remaining Discrepancies).

b. Resolving the Remaining Discrepancies

The law judge found both that Respondents obtained and reviewed third-party documentation in resolving the four remaining Discrepancies, and that their reliance on it to resolve those Discrepancies was reasonable. The first finding is a finding of fact, based on the law judge's assessment of Respondents' uncontradicted testimony.[34] The law judge's finding that Respondents' reliance on the third-party documentation in clearing the Discrepancies was reasonable is, on the other hand, a finding of law requiring an application of the reasonableness standard to particular facts.[35] Because neither the purported letters nor adequate descriptions of their contents are in the record, it is impossible to determine whether Respondents' reliance on such documentation to resolve the Discrepancies was reasonable. Conversely, the Division, which has the burden of proof, was unable to demonstrate that Respondents' reliance was unreasonable because the only evidence on this point is Respondents' testimony. Thus, although the law judge lacked sufficient basis to determine that Respondents' conduct was reasonable, we are unable to conclude that Respondents' conduct in resolving the four remaining Discrepancies was unreasonable.

Under current GAAS, audit documentation must "contain sufficient documentation to enable an experienced auditor, having no previous connection with the engagement," to "understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached," with no provision for recourse to external sources.[36] The absence from the workpapers of documents as critically important as the third-party documents that Respondents relied on to clear the Discrepancies (or a detailed summary of those documents) might well constitute a violation of current GAAS. At the time of the FY 1999 audit, however,

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[34] We note, however, that Meyer's testimony that terms used in the workpapers that ordinarily have one meaning might actually mean something different is troubling. In addition to her testimony that a statement in the workpapers that cash was "appropriately applied" might merely mean that cash was "received," she testified that what she described in the workpapers as a review of "executed contracts" might actually have been a review of "executive vendor correspondence," and that a reference to a "purchasing requirement" might really be to an "internal purchasing target."

[35] *E.g.*, *Russell Ponce*, 54 S.E.C. 804, 817 n.33 (2000) (observing that whether activity was manufacturing or research and development for purposes of GAAP "is a mixed question of law and fact"), *aff'd*, 345 F.3d 722 (9th Cir. 2003).

[36] PCAOB Auditing Standard No. 3.

GAAS did not preclude an auditor from supporting his or her report by other means in addition to workpapers, as the law judge found Respondents did here.[37]

2. Other Red Flags in Cash Receipts Testing

The Division also contends that Respondents encountered many other red flags in the course of cash receipts testing, including apparent irregularities in payment patterns and in the application of payments. For example, copies of some payment checks that went into the PA account have remittances showing payors' notes regarding the application of their payments, but USF's application of the funds was often inconsistent with the payors' notes. The Division contends that in failing to analyze these red flags more closely, Respondents failed to show due care and to gather sufficient competent evidential matter to support their audit conclusions.

It is unclear, however, how many of the checks and remittance copies underlying these red flags Respondents personally saw. Meyer testified, without contradiction, that she could remember seeing the three largest checks that gave rise to the Discrepancies, but could not remember which other checks she saw. There is no testimony that Meyer, as opposed to some other member of the audit team, was shown copies of particular checks. Without evidence that Meyer saw specific checks raising application problems, we cannot conclude that it was unreasonable for Respondents to have failed to follow up on those red flags.[38]

KPMG's files contain a chart showing details of questionable applications of payments. We believe that a reasonable auditor would have noticed red flags upon review of this detailed chart. However, the record does not establish who prepared the chart or whether Respondents knew about the chart or the information it contained, and the chart is not contained in the audit workpapers. Because the record does not show that they were aware of the chart, Respondents cannot be found to have failed to exercise due care or maintain an attitude of professional skepticism with respect to the information contained in it.

The audit workpapers contain a different chart that presents some of the same information shown on the chart found in KPMG's files, and it is reasonable to expect that Respondents would have been aware of the chart in the workpapers. However, the questionable applications are less obvious on the workpaper chart, and the information presented on its face is too innocuous to rise to the level of a red flag. The record therefore does not establish that Respondents failed to

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[37] AU §339.01 n.3; *cf. Gregory C. Dearlove*, 92 SEC Docket at 1883 n.39 (finding lack of any evidence in workpapers or elsewhere in the record to be evidence that audit team did not devote substantial, if any, effort to review the areas in question).

[38] If another member of the audit team reviewed the checks and remittances and failed to brief Meyer about them adequately, this might raise questions regarding GAAS standards pertaining to staffing or supervision; no violation of those standards was charged or litigated here.

exercise due care or maintain an attitude of professional skepticism with respect to the information contained in the workpaper chart.

3. Application Issues in Subsequent Cash Receipts Testing

The Division contends that Respondents acted unreasonably in not following up on irregularities encountered in subsequent cash receipts testing, where the application of some payments lacks any evident rationale. The Division bases its argument on the assumption that Respondents' testing of "application" meant the usual auditing practice in conducting subsequent cash receipts testing: examining checks and remittances to see whether a particular vendor's PA payment was applied against that vendor's PA receivable. Such an examination here would have revealed a complex tangle of applications of money where, for example, payments made by several entities were applied against a receivable of yet another, apparently unrelated, entity. Unraveling this tangle could have led to the discovery of accounting irregularities, at least, and perhaps of fraud.

There is no apparent reason why Respondents would have performed subsequent cash receipts testing for the more limited purpose to which they testified, *i.e.*, to verify that money broadly characterized by USF as PA income was being applied against the broad category of PA receivables.[39] However, in light of the law judge's apparent acceptance of Respondents' testimony, and in the absence of contradictory record evidence, we cannot find that it was unreasonable that Respondents failed to notice red flags that would have been apparent had they been conducting a more detailed application testing. For these reasons, we find that the record does not establish that Respondents' conduct with respect to the cash receipts testing procedures in the FY 1999 audit constituted an unreasonable departure from GAAS.

C. Confirming Vendor Receivables

GAAS define the confirmation process as "obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions."[40] Accordingly, GAAS require the auditor to "direct the confirmation request to a third party who the auditor believes is knowledgeable about the

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[39] There was not, under the circumstances of this audit, a GAAS requirement that subsequent cash receipts testing be performed at all. However, GAAS requires that, for any audit procedure undertaken, the auditors must diligently perform the procedure in compliance with all applicable GAAS.

[40] AU § 330.04.

information to be confirmed."[41] AU Section 330.27 emphasizes that particular circumstances may require heightened skepticism:

> If information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity comes to the auditor's attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including determining whether other procedures are necessary. . . . In these circumstances, the auditor should consider whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect the response will provide meaningful and competent evidence.[42]

Respondents did not act improperly in obtaining confirmation names and addresses from management in the first instance; management is ordinarily in the best position to provide such information. The Division contends, however, that Respondents should have independently investigated each of the addressees, for example by contacting the vendors and addressees, reviewing underlying invoices and other USF accounting records, and/or considering the audit evidence provided by the cash receipts testing.

The Division contends that it was clear at the time of the FY 1999 audit that Respondents were not allowed to use contact information provided by USF management without taking steps to verify that the addresses they were given were truly those of persons knowledgeable about the information to be confirmed. They contend that our decision in *Seidman & Seidman*[43] and the AICPA's Report of the Special Committee on Equity Funding ("Equity Funding Report")[44] required auditors to validate addresses.

Neither *Seidman & Seidman* nor the Equity Funding Report requires Respondents to do more than they did to ascertain that the addresses they used were valid. In *Seidman & Seidman*, the auditors essentially relied on their client's employees to conduct confirmation procedures without supervision or testing by the auditors.[45] Such an abandonment of audit responsibilities is not at issue here. The Equity Funding Report states that ascertaining that valid addresses are used "is already a customary and integral part of confirmation procedures," but it does not explain what validation procedures are required.

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41 AU § 330.26.

42 AU § 330.27 (footnote omitted).

43 46 S.E.C. 524, 543 (1976).

44 Report of the Special Committee on Equity Funding 32 (AICPA 1975).

45 46 S.E.C. at 543.

We find that Respondents' use of the addresses received from USF management must be viewed in the context of their entire experience in auditing USF. Some of the addressees had returned confirmations in connection with the 1998 audit, indicating their familiarity with the balances to be confirmed. Respondents had received assurances from management that the 1998 addresses were suitable. The USF corporate controller's quick review of the FY 1999 letters indicated to Meyer that he saw nothing questionable about the choice of recipients. Because Respondents had amassed considerable knowledge, both about USF's business generally (including the nature of relationships between USF's vendors and the brokers they worked with) and about specific vendors, we decline to find that Respondents were required to conduct further investigation before using the addresses under the standards expected of a reasonable accountant at the time.

The Division contends that audit evidence provided by the cash receipts testing should have led Respondents to investigate the addressees more closely. However, Respondents were actively pursuing resolution of the Discrepancies, and because their efforts appeared to be leading in the direction of resolution, their work on the Discrepancies did not require them to exercise heightened skepticism with respect to confirmation addressees.

For these reasons, we find that the Division did not establish that Respondents' conduct with respect to the confirmation procedures in the FY 1999 audit constituted an unreasonable departure from GAAS.

III.

The Interim Review of Quarterly Financial Information

The Division contends that Respondents' review of USF financial statements for the second quarter ended January 1, 2000 reflected an additional unreasonable departure from "applicable professional standards." As an initial matter, the initial decision included dicta questioning whether a quarterly review should serve as a basis for Commission discipline. Rule 102(e) covers "generally accepted standards routinely used . . . in the preparation of statements, opinions, or other papers filed with the Commission."[46] Thus, the Rule offers no support for such an assertion. The Rule focuses on violations of "applicable professional standards," not on any particular accounting or auditing procedure. As discussed below, AU § 722 establishes professional standards applicable to interim reviews. Restricting the Rule's application to audits would undermine its effectiveness as a "remedial tool . . . cover[ing] a range of conduct that demonstrates that a professional is a future threat to the Commission's processes."[47]

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46 *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,166.

47 *Id.*

A. Applicable Professional Standards: AU Section 722

The objective and procedural requirements for interim reviews are set forth in AU Section 722. In contrast to an audit, where the objective "is to provide a reasonable basis for expressing an opinion" regarding whether financial statements taken as a whole comply with GAAP,[48] the objective of a review of interim financial information is to provide "a basis for reporting whether material modifications should be made for such information to conform with [GAAP]."[49]

An interim review requires the accountant to apply "his or her knowledge of financial reporting practices to significant matters of which he or she becomes aware through inquiries and analytical procedures," but does not require the accountant to conduct all of the procedures generally performed during an audit.[50] An interim review, unlike an audit, does not generally contemplate "tests of accounting records through inspection, observation, or confirmation" or generally require evidence corroborating management's statements.[51] An interim review accordingly provides "limited assurance" or "negative assurance" that the financial statements comply with GAAP. It may reveal "significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit."[52]

The inquiries and analytical procedures involved in the review process include comparisons of the interim financial statements with previous statements and the accountant's expectations, as well as assessments of "plausible relationships among both financial and, where relevant, nonfinancial data."[53] If the accountant learns something during the review "that leads him or her to question whether the interim financial information . . . conforms with [GAAP], the accountant should make additional inquiries or employ other procedures he or she considers appropriate to provide the limited assurance for a review engagement."[54] For instance, upon discovery of any "significant changes in accounting practices or in the nature or volume of the client's business activities," the accountant "should inquire about the manner in which the

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48 AU § 722.09.

49 *Id.*

50 *Id*.

51 *Id.*

52 *Id.*

53 AU § 722.13(b).

54 AU § 722.18.

changes and their effects are to be reported."[55] Circumstances requiring additional inquiries include "extraordinary, unusual or infrequently occurring transactions; significant changes in related parties or related-party transactions; . . . or the development of other contingencies."[56]

AU Section 722 instructs the accountant to direct these inquiries to executives responsible for financial and accounting matters.[57] Management's responses to these inquiries, though generally not requiring corroboration, should be assessed for "consistency . . . in light of the results of other inquiries and the application of analytical procedures."[58] "Deferrals, accruals, and estimates at the end of each interim period are frequently affected by judgments made at interim dates concerning anticipated results of operations for the remainder of the annual period."[59]

If the accountant "become[s] aware of matters that cause him or her to believe that interim financial information . . . is probably materially misstated as a result of a departure from [GAAP]," the accountant should discuss those matters with "the appropriate level of management."[60] If management does not appropriately address these concerns, the accountant should contact the audit committee.[61]

B. Background

1. Payments to United Signature Foods During the Second Quarter of FY 2000

The OIP's allegations with respect to the interim review focus on USF payments to United Signature Foods ("Signature"). During the prior fiscal year, USF sold Signature manufacturing assets, conditioned on USF's agreement (the "Supply Agreement") to purchase approximately $750 million of products produced by Signature over a six-year period. The Supply Agreement included yearly purchasing targets, and required USF to pay a shortfall penalty ("Shortfall Penalty") if purchasing for any contract year fell below 95% of the applicable annual target.

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55 AU § 722.16.

56 *Id.*

57 AU § 722.13(f).

58 AU § 722.13(b).

59 AU § 722.08.

60 AU § 722.20.

61 AU § 722.21.

Each month Signature sent USF a notice calculating USF's purchases for the preceding three months and annualizing this three-month amount. If the annualization was less than 85% of the annual target for the corresponding contract year, the Supply Agreement required USF to pay a projected shortfall penalty ("Projected Penalty"). Unlike Shortfall Penalties, Projected Penalties were refundable if, and to the extent that, the total Projected Penalties paid exceeded the Shortfall Penalty amount due at year-end based on USF's actual purchasing during the contract year.

Respondents reviewed the Signature transaction for the FY 1999 audit, and described the transaction in a memorandum (the "Audit Memo") and the notes to the FY 1999 audited financial statements. Those descriptions stated that USF accounted for the asset sale and the Supply Agreement as a single transaction resulting in a net gain of approximately $78 million. USF deferred most of this gain based on Signature's reliance on its purchases and its substantial purchasing obligations under the Agreement. USF planned to recognize the deferred gain over the six-year term of the Supply Agreement. Both the audited financial statement notes and the Audit Memo noted the annual purchase targets and referenced "penalties" for failure to purchase "the minimum product quantities specified" in the Supply Agreement. The Audit Memo further stated, "[t]o the extent that payments are made in any year for failure to meet the minimum purchase targets[,] they will be recorded as incurred." Neither the Audit Memo nor the notes to the financial statements made any mention of the monthly annualizations triggering Projected Penalties.

USF was unable to meet the contractual purchasing targets for the first contract year. However, Signature did not charge a Shortfall Penalty. Instead, it agreed to amend the Supply Agreement. Under this amendment, dated the last day of FY 1999 (the "Amendment"), USF agreed to pay a "Cash Flow Deposit" of $3,251,100. Unlike a Shortfall Penalty, this amount was not forfeited upon payment but was instead treated as an "an advance payment" for future USF payment obligations under the Supply Agreement.

USF's continuing difficulties meeting the purchasing levels contemplated by the Supply Agreement were reflected in the monthly Signature notices during the second quarter of the next fiscal year. These notices charged USF Projected Penalties of approximately $3.2 million in October 1999, $3.3 million in November 1999, $3.0 million in December 1999, and $2.7 million in January 2000. The notices were addressed to USF's general counsel, and copied the USF manager responsible for monitoring its purchasing under the Supply Agreement, and (except for the October notice) the chief financial officer. USF paid these charges and accounted for them as a reduction in the deferred gain from the Signature transaction. Because the payments were recorded as a reduction in deferred gain rather than as an expense, they did not impact USF's reported income in its quarterly financial statements.

2. Discovery of Signature Payments During the Interim Review

Hall and Meyer were not aware of USF's difficulty in meeting the first annual target and, in response to their direct questions, management did not disclose the existence of any amendments to the Supply Agreement. During the interim review, however, Meyer noticed that the deferred income from the transaction had significantly decreased from the FY 1999 amount. Based on discussions with USF's accounting department, Meyer understood that the reduction in deferred gain related to approximately $13-15 million in payments to Signature.

Meyer discussed these payments with the chief financial officer and general counsel, who described them as "cash flow deposits" for future purchases. At the hearing, she also testified that USF's accounting records identified the payments as "cash deposits." She testified that "at no time did [she] believe or understand [the purchasing] to be below minimum purchasing requirements in the contract," and that she had not generally been concerned about USF's ability to meet the annual targets because she understood that the targets were based on historical purchasing levels and that USF sales were growing. Meyer testified:

> The payments, as I understood them, were not penalty payments . . . . US Foodservice was [Signature's] main customer, and it certainly made sense that if they were not meeting every purchase dollar that they wanted to, that [Signature] needed cash flow to continue to operate and manufacture the product that they needed.

Meyer's workpaper notes state, "13M in pymts to United – Not meeting purchasing requirements." During the hearing, Meyer maintained that this notation referenced USF's "internal targets" or "internal projections" and not contractual targets. Her cross-examination by the Division included the following exchange:

Q: So you understood at the time that if the company fell below the 85 percent threshold target during any 13-week period, that significant penalties would have to be paid?
A: Could be, yes, sir.
. . . .
Q: And, in fact, KPMG had advised or had concluded that, in the event that the company made such shortfall penalties, that those penalties would be . . . . recorded as incurred?
A: Yes.
Q: You would agree the language in your [Audit Memo], it says recorded as incurred, in fact means that the penalties would be expensed?
A: The penalties, if they were penalties, that was my understanding.

Meyer also discussed these payments with Hall, who testified that the description of payments as "cash deposits to help United Signature with cash flow" "seemed reasonable." Hall also testified that he had "a vague recollection of discussing the matter with [the chief financial officer], and he indicated, as I recall, that they were going to make the purchase commitment as of the end of the fiscal year and that they would not incur any penalties under the contract." Like Meyer, Hall testified that he had been familiar with the Projected Penalties calculation based on the prior fiscal year review of the Supply Agreement, but that "[t]here was never any concern" about USF's ability to meet the contractual purchasing targets," and that he did not know that purchasing had fallen below the 85% mark during that quarter. He testified that he did not recall whether he had any conversations regarding the extent of the decline in purchasing, but referred to "the representations we historically got from the company" regarding its compliance with its contractual obligations. Respondents were not aware of the monthly notices demanding Projected Penalties and did not speak with the purchasing manager during the review.

Hall also distinguished Shortfall Penalties and Projected Penalties. He testified that "[P]rojected [P]enalties that are paid during the interim [periods] . . . are not penalties" because they "were recoverable to the extent that [USF] achieved the target by the end of the fiscal year."

C. Analysis

Generally, an issuer's losses must be expensed, or charged to income, when incurred. Statement of Accounting Standards No. 5 ("FAS 5") outlines USF's accounting and reporting obligations for the contingencies at issue in this case.[62] A loss contingency is "an existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm . . . the incurrence of a liability."[63] FAS 5 requires a loss contingency to be expensed if both (a) "Information available prior to issuance of the financial statements indicates that it is probable that . . . a liability had been incurred at the date of the financial statements;" and (b) "the amount of the loss can be reasonably estimated."[64] FAS 5 further provides that disclosure, rather than a charge to income, is required if the contingent loss is reasonably possible,[65] and that gain contingencies should usually not be recorded until the gain is realized.[66] As applied here, the inquiry would focus on whether USF would fail to meet the annual purchasing target, resulting in forfeiture of a previously paid Projected Penalty and/or the assessment of a Shortfall Penalty.

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[62] On June 30, 2009, the Financial Accounting Standards Board ("FASB") issued the FASB Accounting Standards Codification™ ("FASB ASC"), and established the FASB ASC as the source of authoritative U.S. GAAP. FASB ASC is effective for interim and annual periods ending after September 15, 2009. *See Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification*, Exchange Act Rel. No. 60519A (Aug. 19, 2009), 96 SEC Docket 19829. The provisions of FAS 5 are currently codified primarily in FASB ASC Topic 450, Contingencies. Because the conduct at issue took place prior to the codification, we continue to use the designation FAS 5 in this opinion.

[63] FAS 5 ¶ 1.

[64] *Id.* ¶ 8.

[65] *Id.* ¶ 10.

[66] *Id.* ¶ 17.

The Division contends that Respondents failed to reasonably assess whether the payments to Signature during the quarter, which the Division characterizes as "apparent penalties," should have been expensed under FAS 5 as evidence of a probable (*i.e.*, likely) and estimable failure to meet Supply Agreement purchasing targets. The law judge deemed Respondents' review reasonable, finding that USF "maintained that it was behind on its own internal purchasing targets" and "never represented . . . that the payments were penalty payments."

On appeal, the Division contends that Respondents failed to apply appropriate professional skepticism to the cash flow payment explanation from management. Faulting Respondents for failing to question the purchasing manager or to employ additional inquiries or procedures, the Division argues that Respondents violated their obligation to follow up on information raising questions about the compliance of the financial statements with GAAP. The Division contends that Respondents had an obligation to further test managements' explanations, arguing that "[t]here is no rational reason why Signature would accept 'cash flow deposits' when the contract by design provided for penalties to address the exact situation."

However, a review "does not involve obtaining corroborating evidential matter for responses to inquiries" or "search and verification." On the one hand, the symbiotic relationship between the two companies and USF's Form 10-K disclosure regarding warehouse consolidation supported the plausibility of the cash flow/internal targets explanation. In addition, although Respondents were not aware of the Amendment during the review, the Amendment contradicts the Division's contention that Signature's willingness to be flexible regarding USF's purchasing obligations was implausible as a business matter.

On the other hand, we agree with the Division that Respondents' assessment of management's explanations for plausibility should also have taken into account the monthly Projected Penalty calculations required under the Agreement. Both Respondents testified that they were familiar with the Projected Penalty provisions but that they were not aware that USF's purchasing had fallen below the 85% target calculation. Given this knowledge, a reasonable inquiry regarding payments to Signature based on a downturn in purchasing should have directly asked whether such payments, regardless of the nomenclature applied to them, had been triggered by the Projected Penalty obligations in the Agreement. However, Respondents' testimony did not directly address whether their review inquiries focused on this key issue.

Moreover, regardless of whether management characterized the payments as "penalties," "cash flow payments," or "advances," because Respondents knew that USF's rights with respect to these payments depended on future events, the accounting for such payments should have triggered a consideration of FAS 5. Such analysis could have appropriately considered both the "probable and estimable" test for recognition of a loss contingency and the guidance disfavoring recognition of gain contingencies. The contractual Projected Penalty calculations should have informed this FAS 5 analysis, and Respondents should have considered the plausibility of management's explanations in light of their understanding of those calculations.

On the record before us, however, we cannot determine whether Respondents considered the appropriate contractual provisions as part of a FAS 5 assessment. The testimony on this point is ambiguous, in part due to the inconsistent use of key contractual terms during the hearing. For instance, the Signature payments at issue were repeatedly described as Shortfall Penalty payments (assessed annually under the Agreement) despite clear record evidence that the payments made during the quarter were Projected Penalty payments (assessed monthly). Also, although Meyer testified that "[a]t the time [she] was doing this work, there was no discussion of penalty payments," it is unclear from the context, and Meyer was not asked to clarify, whether this statement referred to either or both Projected Penalty and Shortfall Penalty payments.

The contractual differences between Shortfall and Projected Penalty payments were significant for FAS 5 purposes. Because Shortfall Penalties were based on a final year-end calculation, GAAP required any such payments to be expensed as a loss when probable and reasonably estimable.[67]

Projected Penalty payments, however, were based on projections and were subject to refund pending the Shortfall Penalty calculation of purchasing volume for the entire year. The correct accounting treatment for a known Projected Penalty payment presents a close judgment call as to which reasonable accountants could disagree. Here, Respondents' expert suggests that the payment of a Projected Penalty should have triggered a facts-and-circumstances based analysis of the likelihood of achieving the year-end purchasing target. The Division's expert suggests that the actual payment of a Projected Penalty is evidence of a likely failure to meet the annual target triggering an obligation to expense, and that the failure to expense the payments amounted to a premature recognition of a gain contingency.

Both approaches are grounded in relevant accounting guidance. The facts-and-circumstances based analysis espoused by Respondents' expert is supported by interim review guidance indicating that interim financial statements may appropriately reflect management judgements at that time "concerning anticipated results of operations for the remainder of the annual period,"[68] and FAS 5 guidance indicating that the recognition of a contingent loss must be based on a "probab[ility] that one or more future events will occur confirming the fact of the loss." This guidance supports an accounting approach based on management representations regarding the probability of future refund or application of payments prior to contract-year end. FAS 5 guidance disfavoring premature recognition of contingent gains, however, could be read to support an approach requiring automatic recognition of any Projected Penalty as a contingent loss, as described by the Division's expert.

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[67] Meyer testified that "the penalties, if there were penalties" should have been expensed, but that "in [her] understanding, these [payments] were not penalty payments."

[68] AU § 722.08.

In any event, the relevant question under Rule 102(e) is not whether the accounting for the payments reflected in the financial statements was correct, but whether Respondents' review of the accounting was reasonable in light of the relevant FAS 5 guidance and their knowledge of the Supply Agreement.[69] The interim review workpapers offer minimal and ultimately ambiguous evidence in this regard. The only other record evidence is Respondents' testimony and several statements in the report of Respondents' expert.

Hall's testimony was generally consistent with the Respondents' expert's emphasis on the FAS 5 "probable and estimable" standards for recognition of a contingent loss. Hall emphasized the distinction between Shortfall Penalties and Projected Penalties, stressing that Projected Penalties would be refunded "to the extent that [USF] achieved the target by the end of the fiscal year" and focusing on USF's assurances that annual contractual targets would be met. Similarly, Respondents' expert report describes Meyer's assessment in terms of the contingent loss factors, indicating that "Ms. Meyer was . . . told by USF management that USF intended to and could meet the contractual purchasing requirements by the end of the contract year and thus the possibility that USF would incur penalties under the contract was remote."

Although the Division contends that Hall and Meyer should have further tested or questioned management's explanations, the Division did not press Respondents at the hearing about the degree to which they did so. For example, the Division's expert report stated that Respondents should have asked management, "Why would Signature accept a prepayment from USF when instead it had the contractual ability to charge USF penalties?" At the hearing, however, the Division did not ask Respondents whether they asked or considered this question.

Some of Respondents' testimony could be read as supporting the Division's contention that Respondents failed to appropriately evaluate management's explanations for the payments against the Projected Penalty payment calculations required under the Supply Agreement. For instance, Hall testified that he did not recall asking how far below the threshold USF's purchasing had fallen during the quarter, and Meyer testified that "[a]t the time [she] was doing this work, there was no discussion of penalty payments." Ultimately, however, this testimony is not conclusive in light of the inconsistent use of key contractual terms during the examination of Respondents at the hearing as described above, and because Respondents were not directly asked to explain whether their FAS 5 assessment took the Projected Penalty calculations into account.[70]

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[69] *See, e.g.*, *Dearlove*, 92 SEC Docket at 1889-90 & n.51 (accountant's conduct may violate GAAS even if the underlying financial reporting complies with GAAP).

[70] The Division's suggestion that Respondents should have questioned the purchasing manager diverges from interim review guidance directing inquiries to officers with responsibility for "financial and accounting matters" rather than employees with operational responsibility, and stating that responses to inquiries during a review do not need to be supported by corroborating evidential matter.

(continued...)

Given the limited assurance standard for interim reviews and gaps in the development of potentially dispositive record evidence, we believe that the record does not establish, by a preponderance of the evidence, that Respondents' conduct during the interim review was an unreasonable departure from applicable professional standards.

V.

Respondents' Due Process Claims

A. Background[71]

In opening its investigation of USF accounting practices in early 2003, the Division issued a document subpoena covering professional services provided to USF by Respondents. In April 2005, the Division issued Wells notices to notify Respondents that it was considering recommending that the Commission institute administrative proceedings against them, and offering Respondents an opportunity to submit a statement to be forwarded to the Commission in conjunction with the Division's enforcement recommendation.[72] Respondents submitted a joint Wells submission through their then-counsel ("Former Counsel") in May 2005.

Separately, in July 2005, we authorized a preliminary investigation into whether certain counsel, including Former Counsel, had engaged in conduct subject to discipline under Rule

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70 (...continued)
Respondents note that both the chief financial officer and the general counsel knew that the payments were Projected Penalty payments, but instead characterized the payments as cash flow payments in response to Respondents' direct inquiries. The Division expert's suggestion that Respondents' assessment of management's responses should have taken into account the management "integrity issues" from the previous year's audit assumes that Respondents were, at that time, aware of reason to question management's integrity. The record does not include evidence that Respondents harbored such suspicions during the review.

71 Respondents have moved to limit public disclosure of their arguments regarding the Division's investigation. On July 20, 2009, we issued an order granting Respondents' motion. Exchange Act Rel. No. 60346 (July 20, 2009), 96 SEC Docket 18986. As noted in that order, the requirements of sealing and confidentiality do not apply to "any reference to the existence of the [c]overed [a]rguments or to citation of particular information contained therein" in, among other things, the opinion "or in any other similar use directly connected with this action or any appeal thereof." Although we are dismissing this action, because of their potential significance in future cases, we address Respondents' due process claims separately in this Section V.

72 *See* 17 C.F.R. § 202.5(c). This is known as the Wells process.

102(e) (the "Counsel Investigation"). Consistent with Commission rules, we directed members of the Office of General Counsel ("OGC") to conduct the Counsel Investigation.[73]

The Counsel Investigation was non-public,[74] and Commission staff did not inform Respondents of the Counsel Investigation when it was initiated. Former Counsel continued to represent Respondents, including in correspondence and meetings with the Division, between May and August 2005. In October 2005, Former Counsel, joined by new counsel for Hall,[75] submitted a second, superseding joint Wells submission ("Superseding Wells Submission"). Respondents state, and the Division does not dispute, that Respondents were not subpoenaed to provide sworn testimony during the investigation. In January 2006, OGC advised Former Counsel of the Counsel Investigation. The Counsel Investigation was subsequently closed without any action being brought.

In February 2006, we issued the OIP for this case. The OIP included allegations, among other things, that Respondents reviewed USF contracts containing prepayment provisions (the "Prepayment Review Allegations"). In March 2006, new counsel entered a notice of appearance on behalf of Meyer (together with Hall's new counsel, "Current Counsel").

The hearing before the law judge was originally scheduled to begin in March 2006, but was stayed until April 18, 2007 upon a motion by the United States attorney for the Southern District of New York. On April 20, 2007, the Division indicated that it had decided not to pursue the Prepayment Review Allegations at the hearing. On June 20, 2007, Respondents filed an interlocutory motion with the Commission seeking dismissal of the proceedings. Respondents contended, among other things, that the Counsel Investigation deprived them of effective assistance of counsel and that the Commission's decision to institute proceedings was "tainted" by the Division's investigation. We denied Respondents' motion, indicating that "once we have exercised our prosecutorial discretion to institute a proceeding, the appropriate remedy for any challenge to that exercise of discretion is to litigate the proceeding to a final decision." Respondents renewed their due process claims during the hearing, but the law judge rejected these claims, ruling that the hearing satisfied their due process right to defend themselves against the charges.[76]

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[73] OGC, rather than the Division, is charged with investigating and prosecuting potential violations of Rule 102(e) by attorneys. 17 C.F.R. § 200.21(a).

[74] 17 C.F.R. § 202.5(a) ("Unless otherwise ordered by the Commission, the investigation . . . is non-public and the reports thereon are for staff and Commission use only.").

[75] The circumstances prompting Hall's substitution of new counsel are not evident from the record.

[76] The administrative law judge issued a separate decision under seal addressing

(continued...)

B. Respondents' Contentions

On appeal, Respondents argue that their due process claims constitute independent grounds for dismissal of the Rule 102(e) charges. Respondents argue that the Division had a duty to inform them of the Counsel Investigation when it was initiated, and that the Division "deprived [them]. . . of the opportunity to knowingly exercise [their] choice of counsel" when it did not make this disclosure. Asserting that the Counsel Investigation created a conflict of interest violating their right to effective representation, Respondents claim that this right was violated "the moment that Former Counsel was ineffective" due to the initiation of the separate Counsel Investigation. Respondents further contend that the Division engaged in an "incomplete and biased" investigation that rendered our issuance of the OIP arbitrary and capricious. In support of this claim, they focus on the Division's decision not to pursue the Prepayment Review Allegations and the law judge's subsequent decision finding that they had not engaged in improper professional conduct. Respondents argue that our issuance of the OIP caused them reputational harm. Finally, Respondents argue that the investigation violated Commission ethical guidelines. We address these contentions in turn.

C. Analysis

1. Choice of Counsel.

The right to counsel before administrative agencies is grounded in section 555(b) of the Administrative Procedure Act ("APA"), which entitles a "person compelled to appear in person before an agency or representative thereof . . . to be accompanied, represented, and advised by counsel."[77] Commission rules, echoing the APA right, cover "[a]ny person compelled to appear, or who appears by request or permission of the Commission, in person at a formal investigative proceeding,"[78] and a "witness who is sworn in a proceeding pursuant to a Commission order for investigation or examination."[79] This provision of the APA had not attached during Former Counsel's involvement in the Division's investigation because Respondents were not compelled

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76 (...continued)
Respondents' procedural contentions. The factual findings in this Section V of the opinion rely primarily on stipulations of fact submitted under seal to the administrative law judge by the Division and Respondents.

77 5 U.S.C. § 555(b). The APA also entitles parties to agency proceedings to appear with counsel. *Id.*

78 17 C.F.R. § 203.7(b); *see also* 17 C.F.R. § 201.102(b) ("In any proceeding, a person may be represented by an attorney at law. . . .").

79 17 C.F.R. § 203.4(a).

to appear or to provide sworn testimony during the investigation.[80] Although Former Counsel filed written submissions on behalf of Respondents as part of the Wells process, this process is conducted at the Division's discretion[81] and does not confer procedural rights.[82]

A Commission investigation does not confer any party with a general right to information about the Division's view of their counsel, or any potential parallel investigations. In suggesting the contrary, Respondents rely on cases applying the right to counsel under the APA "to imply the concomitant right to the lawyer of one's choice," and preventing the Commission from sequestering a witness from counsel during sworn testimony.[83] In those cases, however, the respondents asserted that the Commission directly interfered with their consultation with counsel during testimony. Respondents here do not allege interference in their ability to consult with the counsel of their own choosing either before or after these proceedings were instituted.

2. Effective Assistance of Counsel.

Although Respondents attempt to characterize their claim as a deprivation of their right to effective assistance of counsel, the Commission does not have a general obligation to ensure the competence or suitability of Respondents' representation during an investigation.[84] Fifth

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80 A requirement investing all parties potentially implicated in an investigation with such procedural rights would be "virtually impossible" to administer and "'would unwarrantedly cast doubt upon and stultify the [Commission's] every investigatory move.'" *SEC v. O'Brien*, 467 U.S. 735, 749 & 751 (1985) (quoting *Donaldson v. United States*, 400 U.S. 517, 531 (1971)).

81 *See* 17 C.F.R. § 202.5(c) (describing the Wells process by stating: "Persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation. Upon request, the staff, in its discretion, may advise [persons under investigation] of the general nature of the investigation . . . .").

82 *Wellman v. SEC*, 79 F.R.D. 341, 353 (S.D.N.Y. 1978).

83 *See SEC v. Higashi*, 359 F.2d 550, 553 (9th Cir. 1966) (applying the APA provision to subpoenaed testimony); *SEC v. Csapo*, 533 F.2d 7, 10 (D.C. Cir. 1976) (interpreting the statutory right to cover "any person summoned to appear before a federal agency").

84 In fact, administrative proceedings generally do not trigger a specific right to the effective assistance of counsel. *Hammon Capital Mgmt. Corp.*, 48 S.E.C. 264, 266 (1985); *see also Williams v. Wynne*, 533 F.3d 360, 369 (5th Cir. 2008) (finding Sixth Amendment inapplicable to an administrative hearing); *Father & Sons Lumber & Bldg. Supplies v. NLRB*, 931 F.2d 1093, 1096-97 (6th Cir. 1991) (finding that neither the Fifth Amendment nor the APA conferred a separate right to effective assistance of counsel in an administrative hearing).

Amendment due process principles protecting the "right to a fair and impartial hearing"[85] apply to adjudicative, not investigative, processes.[86] These protections are satisfied by the "opportunity to appear as a claimant and to have a full hearing" in connection with the charged violations.[87] Accordingly, the preliminary determination to institute a proceeding does not trigger due process protections "so long as the requisite hearing is held before the final administrative order becomes effective."[88] Government actions taken before the institution of proceedings trigger a due process remedy only if such conduct both actually prejudiced the defense at the hearing and constituted "an intentional device to gain tactical advantage" at the hearing.[89]

Respondents have not alleged or demonstrated either of these required elements for due process relief.[90] Effective assistance inquiries based on counsel conflicts of interest, like other

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[85] *Friedman v. Rogers*, 440 U.S. 1, 18 (1979).

[86] *O'Brien*, 467 U.S. at 742 (holding that targets of SEC investigations are not entitled to notice of third party subpoenas and stating that "an administrative investigation adjudicates no legal rights" (citing *Hannah v. Larche*, 363 U.S. 420, 440-43 (1960)).

[87] *Ewing v. Mytinger & Casselberry, Inc.*, 339 U.S. 594, 598 (1950); *see also Withrow v. Larkin*, 421 U.S. 35, 46 (1975) (stating that administrative agencies have an obligation to provide a "fair trial in a fair tribunal" as "a basic requirement of due process").

[88] *Ewing*, 339 U.S. at 598.

[89] *United States v. Marion*, 404 U.S. 307, 324 (1971) (finding that a delay in indictment did not constitute a due process violation); *see also United States v. Stringer*, 521 F.3d 1189, 1200 (9th Cir. 2008), *amended in part*, 535 F.3d 929, 933 & 941 (9th Cir. 2008) (suggesting that government "deceit or an affirmative misrepresentation" interfering with a client's relationship with counsel will give rise to potential due process claim if such conduct resulted in "actual and substantial prejudice" to the client's defense during the trial).

[90] Although Respondents cite cases discussing the rights of criminal defendants under the Sixth Amendment, these cases are inapplicable to administrative proceedings because "Sixth Amendment [protections] are explicitly confined to 'criminal prosecutions,'" *Austin v. United States,* 509 U.S. 602, 608 (1993), and only attach after the formal institution of such criminal proceedings. *Massiah v. United States*, 377 U.S. 201, 205 (1964) (indicating that the right attaches from the time of the arraignment).

Moreover, Respondents improperly conflate authority addressing two distinct rights under the Sixth Amendment -- the right to choice of counsel and the right to effective representation. The authority cited by Respondents, however, expressly distinguished between "the right of counsel of choice -- which is the right to a particular lawyer regardless of comparative effectiveness" and "the right to effective counsel -- which imposes a baseline

(continued...)

due process claims, focus on the adjudication of the charged person's legal rights.[91] For instance, we have disqualified an attorney from participating in a hearing when the attorney's divided loyalties posed a potential threat to "the apparent fairness and integrity of the proceedings."[92] Respondents here do not cite any evidence, however, that their right to a fair and impartial adjudication of the charges against them -- the touchstone of due process -- was compromised by their representation by Former Counsel during the investigation.

In addition, Respondents have not shown that any of the Division's decisions during its investigation constituted bad faith efforts to frustrate Respondents' ability to defend themselves against the charges, or to undermine the integrity of the hearing. In fact, we expressly found in *Trautman Wasserman & Co.*[93] that the non-disclosure of a parallel investigation of respondent's counsel during the Wells process does not constitute grounds for dismissal of charged violations. We held that "the Division's decision during the Wells process to withhold information about certain facts . . . does not give rise to any right or remedy,"[94] and that in any case the substitution of new counsel before the hearing "cur[ed] any alleged harm [respondent] may have suffered because of [his former counsel's] alleged conflict."[95] Here, as in *Trautman Wasserman*, the retention of Current Counsel prior to the hearing averted any potential prejudice to the Respondents' defense, and thereby averted any potential due process harm.

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90 (...continued)
requirement of competence on whatever lawyer is chosen or appointed." *United States v. Gonzales-Lopez*, 548 U.S. 140, 148 (2006). The Court specifically reaffirmed the prejudice requirement for a finding of ineffective assistance. *Id*. at 147. As noted in the text, Respondents were not deprived of their right to the lawyer of their own choosing, and have not shown any prejudice to their ability to defend themselves at the hearing.

91 *Strickland v. Washington*, 466 U.S. 668, 686 (1984) ("The benchmark for judging any claim of ineffectiveness must be whether counsel's conduct so undermined the proper functioning of the adversarial process that the trial cannot be relied on as having produced a just result."); *see also* 2 Am. Jur. 2d *Admin. Law* § 120 (2008) ("As long as no legal rights are adversely determined during the investigation, the demands of due process are satisfied if procedural rights are granted in the subsequent proceedings.").

92 *Clark T. Blizzard*, 55 S.E.C. 650, 655 (2002) (disqualifying counsel proposing to engage in simultaneous representation of parties at a hearing when this representation generated "serious potential for prejudice to the integrity of the proceeding").

93 Exchange Act Rel. No. 55989 (June 29, 2007), 90 SEC Docket 3098.

94 *Id.* at 3106.

95 *Id.* at 3105-3106.

3. **Claimed "Arbitrary and Capricious" Institution of Proceedings**.

Respondents attempt to distinguish *Trautman Wasserman* by claiming that the Division conducted an "incomplete and biased investigation," and that Division bias in turn tainted the Commission's decision to institute proceedings. However, Respondents do not offer any support beyond mere speculation for their claim that the Division was motivated by improper bias in assessing their explanations for their conduct, or in declining to take their investigative testimony. Participants in the investigative process are not entitled to an uncritical or even a neutral Division assessment of their asserted defenses,[96] or to a right to provide investigative testimony.[97] These aspects of the Division's investigation fall squarely within the scope of the prosecutorial discretion that it routinely exercises in conducting multi-party investigations, and it is well established that such investigations do not trigger "the full panoply"[98] of safeguards that are required during an adjudication.[99] This distinction is maintained in order to "prevent the sterilization of investigations by burdening them with trial-like procedures."[100]

In fact, the Supreme Court has recognized the propriety of affording Commission staff "considerable discretion in determining when and how to investigate" potential securities law violations,[101] and the pragmatic considerations weighing against requiring the Division to "inform[] anyone, including targets, of the existence and progress of its investigations."[102] As the Court recognized, such a "remedy would . . . have the effect of laying bare the state of the Commission's knowledge and intentions midway through investigations," and "could significantly hamper the Commission's efforts to police violations of the securities laws."[103]

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96 *See Marshall v. Jerrico*, 446 U.S. 238, 248 (1980) (stating that the neutrality requirements "designed for officials performing judicial or quasi-judicial functions . . . are not applicable to those acting in a prosecutorial or plaintiff-like capacity").

97 *Hannah*, 363 U.S. at 445-46 ("[W]hen these agencies are conducting nonadjudicative, fact-finding investigations, rights such as apprisal, confrontation, and cross-examination generally do not obtain.").

98 *Hannah*, 363 U.S. at 442.

99 *See O'Brien*, 467 U.S. at 742-43 (holding that targets of SEC investigations are not entitled to notice of third party subpoenas).

100 *Hannah*, 363 U.S. at 447-48.

101 *O'Brien*, 467 U.S. at 744-45.

102 *Id.* at 744-45, 749-751.

103 *Id.* at 750 n.23.

Moreover, Respondents' suggestion that the Commission's decision to institute these proceedings could in some way have been tainted by any alleged improper conduct by the Division's investigation ignores the independence of the Commission's decision-making process.[104] We authorized and instituted these proceedings based on our "own consultations, deliberations and conclusions with respect to [the Division's] recommendations."[105] In the course of doing so, we reviewed the Respondents' Wells submission, and Respondents have not pointed to any defense they were prevented from including in this submission in connection with the Counsel Investigation.

The decision to institute proceedings was not meant to resolve disagreements between the Division and Respondents regarding the evidence; such disagreements are best left to be resolved at the hearing authorized by the OIP.[106] The Supreme Court, recognizing the "different bases and purposes" for a charging decision and a subsequent adjudication, has expressly stated that "there is no incompatability between [an] agency filing a complaint based on probable cause and a subsequent decision . . . that there has been no violation."[107] Such a resolution does not demonstrate impropriety in the charging decision or investigation, but rather the nature of the adjudication process itself.

Although the Division chose not to pursue the Prepayment Review Allegations at the hearing, Respondents do not substantiate their claims that the original inclusion of those

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[104] We have previously rejected claims that "disqualifying bias on the part of the Commission may be inferred from alleged bias of its members or staff." *Jean-Paul Bolduc*, 54 S.E.C. 1195, 1199 (2001).

[105] *Edward H. Kohn*, Freedom of Information Act Rel. No. 19, 1975 SEC LEXIS 1217 (July 15, 1975); *see also Stuart-James Co.*, 50 S.E.C. 468, 469 (1991) (stating that the Commission, "not the staff, [is] ultimately responsible for exercising control over the agency's administrative proceeding docket").

[106] *Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Exchange Act Rel. No. 9796 (Sept. 27, 1972) (noting that disputes about facts underlying the institution of proceedings "likely . . . can be resolved in an orderly manner only through litigation").

[107] *Withrow*, 421 U.S. at 57-58. Given this authority distinguishing between the requirements for filing a complaint and the subsequent decision, we reject Hall's suggestion that the Commission must justify the inclusion of these charges in the OIP based on the standard of judicial review for "final agency action" under the APA. Issuance of an OIP is not final agency action. *See FTC v. Standard Oil Co.*, 449 U.S. 232, 493 (1980) (holding that issuance of complaint is not "final agency action").

allegations in the OIP was improper.[108] Moreover, the Division actively pursued the remaining charges, and those charges, if established, would have provided a basis for discipline under Rule 102(e). An order instituting proceedings satisfies the demands of due process if the respondent is "afford[ed] full opportunity to justify [his or her] conduct during the course of the litigation."[109] Respondents have not demonstrated how changes in the Division's presentation of its case in any way prejudiced Respondents' ability to justify their conduct; they have not pointed to any defense to the charged violations that they were prevented from raising during the hearing.[110]

4. Claimed Reputational Harm

Although Respondents claim that the institution of proceedings caused them reputational and professional harm, these claims do not give rise to due process relief unless they prejudiced the hearing process. As noted above, Respondents' attempt to extend procedural protections for adjudications to the investigation is misguided. Even if a government investigation could result

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108 While the record does not specifically state the Division's original basis for recommending the inclusion of the Prepayment Allegations in the OIP, we note that vendor contracts containing prepayment provisions and 1998 audit workpapers initialed by Meyer referencing the review of "executed promotional contracts," "executed contracts," and "vendor contracts" could have suggested to an unbiased investigator that Meyer had, in fact, reviewed such provisions.

109 *Flying Food Group, Inc. v. NLRB*, 471 F.3d 178, 183 (D.C. Cir. 2006) ("[P]leadings in administrative proceedings are not judged by the standards applied to an indictment at common law. . . . Rather, '[i]t is sufficient if the [petitioner] understood the issue and was afforded full opportunity to justify its conduct during the course of the litigation.'" (internal citations and punctuation omitted)); *see also Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 261-62 (D.C. Cir. 1979) (finding no procedural defect when the factual basis for the law judge's decision diverged from the factual allegations in the complaint because "the entire issue was fully litigated in the course of the proceedings before the ALJ and the Board"); *RFG Options Co.*, 49 S.E.C. 878, 885 (1988) (finding no prejudice where nature of charged violation changed during opening statement of the hearing).

110 Even assuming *arguendo* that the OIP was not based on an independent judgment, Respondents "do[] not have a constitutional right to a conflict-free agency determination of whether to sue him civilly unless the conflict laps over into the trial." *Buntrock v. SEC*, 347 F.3d 995, 999 (7th Cir. 2003); *see also United States v. Oregon*, 44 F.3d 758, 772 (9th Cir. 1994) (stating that a due process claim based on allegations of a biased tribunal must at least demonstrate "an unacceptable probability of actual bias" by "the tribunal that will adjudicate [the] claims"); *United States v. Parish*, 468 F.2d 1129, 1133 (D.C. Cir. 1972) ("[T]he concern of the Due Process Clause is erosion of the accused's capability to muster his response to the charges.").

in adverse consequences, including public opprobrium, job loss, or criminal prosecution, such investigation is not subject to the same due process protections observed in proceedings adjudicating legal rights.[111]

5. Claimed Ethical Violations.

Active government deceit or affirmative misrepresentations compromising a respondent's defense at the hearing may implicate due process rights,[112] but Respondents have not demonstrated such misconduct in this case. Nor has Meyer substantiated her claim that the institution of proceedings was inconsistent with Commission ethical canons encouraging "unusually high standards of honesty, integrity, impartiality and conduct" and the "avoidance of actual or apparent misconduct or conflicts of interest," or discouraging Commission staff from "condon[ing] unprofessional conduct by attorneys."[113] Rather than condoning suspected unprofessional conduct, the Division referred suspected misconduct by Former Counsel for further investigation, and the separation of the Counsel Investigation by OGC from the investigation of Respondents' conduct by the Division reflected an institutional safeguard against inappropriate bias.[114] We note that government action is entitled to a presumption of good faith "[i]n the absence of a clear showing of bad faith,"[115] which Respondents have not made here.

The record does not support Respondents' claim that the decision not to take investigative testimony was "contrary to the Commission's long-standing commitment to fundamental fairness," particularly when taking such testimony could have fueled the type of due process challenges Respondents now raise. For instance, disclosure of the Counsel Investigation to Respondents, as Respondents contend was required, in connection with such testimony could have provoked a charge of improper interference in their relationship with Former Counsel.[116]

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111 *Hannah*, 363 U.S. at 443; *see also FTC v. Standard Oil Co.*, 449 U.S. at 244 ("[T]he expense and annoyance of litigation is part of the social burden of living under government." (internal citation omitted)).

112 *See supra* note 89.

113 17 C.F.R. §§ 200.735-2(a), 200.69.

114 *See supra* note 73.

115 *Trautman Wasserman*, 90 SEC Docket at 3105; *see also Withrow*, 421 U.S. at 47 (noting the "presumption of honesty and integrity in those serving as adjudicators"). In any case, violations of "legal or ethical rules governing [Commission] investigations" are "not, without more, a defense to the SEC's suit." *Buntrock*, 347 F.3d at 998.

116 *See Stringer*, 521 F.3d at 1201 (stating that "had the government . . . warn[ed defendant] about [his attorney's] conflict, bypassing his attorney, the government would have

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6. Conclusion

Based on our review of Respondents' contentions, we find that Respondents have not established a violation of their due process rights. Respondents have not demonstrated that circumstances prior to the issuance of the OIP compromised their ability to defend themselves against the charged violations at the hearing.

VI.

Under all the circumstances, and based on our de novo review of the record, we have concluded that the record before us does not establish by a preponderance of the evidence that Respondents committed the offenses charged. We will accordingly dismiss this proceeding.

An appropriate order will issue.[117]

By the Commission (Chairman SCHAPIRO and Commissioners CASEY, WALTER and AGUILAR); Commissioner PAREDES concurs in the findings on the merits but believes that, as the issues addressed in Section V are moot, the opinion should not address them.

Elizabeth M. Murphy
Secretary

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[116] (...continued)
engaged in conduct that itself may have amounted to interference" violating defendant's due process rights).

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

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61162 / December 14, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3080 / December 14, 2009

Admin. Proc. File No. 3-12208

In the Matter of

KEVIN HALL, CPA
and
ROSEMARY MEYER, CPA

ORDER DISMISSING PROCEEDINGS

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

ORDERED that the proceedings instituted on February 16, 2006 against Kevin Hall, CPA and Rosemary Meyer, CPA, be, and they hereby are, dismissed.

By the Commission.

Elizabeth M. Murphy
Secretary