

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9094 / December 17, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61193 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3084 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13722

In the Matter of

MARK V. SEVER, CPA,

Respondent.

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

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), Sections 4C¹ and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), and Rule 102(e)(1)(iii) of the Commission’s Rules of Practice² against Mark V. Sever (“Sever” or “Respondent”).

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

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

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

II.

In anticipation of the institution of these proceedings, Sever has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, which are admitted, Sever consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission’s Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Sever’s Offer, the Commission finds³ that:

Summary

1. This matter involves violations of the federal securities laws and improper professional conduct by Sever in connection with the 2001-2003 audits of Bally Total Fitness Holding Corporation (“Bally”) conducted by Ernst & Young LLP (“E&Y”). From 1997 through the third quarter of 2001, Sever was a Professional Practice Director (“PPD”) in E&Y’s National Office, and served as the Independent Review Partner (“IRP”), or concurring partner, for Bally’s audits. Then, as the National Director of Area Professional Practice, who also developed and implemented E&Y’s Focus Account risk management program, Sever remained involved with Bally’s 2001-2003 audits.

2. In connection with Bally’s 2001-2003 financial statements, Bally engaged in fraudulent financial accounting, including prematurely recognizing revenue and improperly deferring costs, which overstated income and inflated stockholders’ equity, and implementing two improper changes in accounting method rather than restating for accounting errors. Bally also made false and misleading disclosures regarding a \$55 million special charge in its 2002 Form 10-K. On November 30, 2005, Bally filed its 2004 Form 10-K, which restated its

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* * *

(iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

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

previously reported financial statements for 2002 and 2003, and selected financial data for 2000 and 2001.

3. Sever knew or should have known that E&Y's unqualified audit opinions regarding Bally's 2001-2003 financial statements -- which stated that E&Y had conducted its audits in accordance with auditing standards generally accepted in the United States ("GAAS") and that Bally's financial statements were presented in conformity with accounting principles generally accepted in the United States ("GAAP") -- were false because E&Y's audits of Bally's financial statements were not performed in accordance with GAAS and Bally's financial statements were not in conformity with GAAP.

4. As a result of the false and misleading audit opinions, Sever was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act, and was a cause of and willfully⁴ aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13. Sever also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not ensuring that E&Y brought to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the \$55 million special charge.

Respondent

5. Sever is, and was at all relevant times, a Certified Public Accountant licensed in Illinois. From 1997 through the third quarter of 2001, Sever was the PPD for the Lake Michigan Area and also was the IRP on the Bally audits. Sever then was appointed to be the National Director of Area Professional Practice, but he remained involved in Bally's audits.

Issuer

6. Bally, a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

⁴ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

Background

7. For many years up until it resigned in 2004, E&Y audited Bally's financial statements. Bally's principal source of revenue was selling gym membership contracts, which provided customers access to gyms in exchange for the payment of both a one-time initiation fee and monthly dues. The one-time fee was typically several thousand dollars, while the monthly dues typically were less than \$10 per month. Most of Bally's customers financed their initiation fees. To maintain their memberships, customers were required to pay their initiation fee in full and pay monthly dues. The initiation fees were Bally's biggest source of revenue. The obligation to pay the initiation fee was legally enforceable; there was no legal obligation to pay monthly dues beyond the initial contract period.

8. E&Y recognized Bally as a risky audit and, from at least 1996 through 2003, designated Bally as a "close monitoring" account because Bally presented a risk that created "a significant chance the firm [E&Y] will suffer damage to its reputation, monetarily, or both." Bally was designated a close monitoring account for several reasons, including, among other things, that Bally's managers were former E&Y audit partners who were "difficult" and had "historically been aggressive in selecting accounting principles and determining estimates;" the managers placed undue emphasis on maintaining stock prices; management used "(un)reliable . . . estimation process[es] or questionable judgments;" and Bally's compensation plans placed undue emphasis on reported earnings. E&Y's internal guidance notes that a "history of 'aggressive' applications of accounting policies could indicate a predisposition to misstate the financial statements."

9. In early 2002, E&Y sought to reduce its risk by identifying its riskiest clients and resigning from them or otherwise managing the risk they presented to E&Y. Out of a total of over 10,000 audit clients in North America, E&Y identified Bally as one of the riskiest 18 accounts. These 18 accounts were so-called "National Focus Accounts" and were monitored by the Americas Executive Board. Not only was Bally identified as a National Focus Account, Sever knew it was identified as the riskiest account in E&Y's Lake Michigan Area.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Years 2001 And 2002

10. In connection with fiscal years 2001 and 2002, as well as earlier years, Bally engaged in certain practices relating to its recognition of reactivation revenue, initiation fee revenue, and deferred costs that made its financial statements false and misleading. Sever, who knew or should have known of these practices, reviewed and did not object to E&Y's issuance of unqualified audit opinions, in violation of GAAS, in connection with its audits of such financial statements.

Premature Recognition Of Reactivation Revenues

11. Bally recognized revenue from what it called "reactivations," which were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their

membership. Bally did not attempt to recover those dues because there was no legal obligation to pay dues. Accordingly, for those canceled members who had completed the initial contract period, Bally waited at least six months after receiving their last payment and then began soliciting these canceled members to reactivate. Those who accepted the reactivation offers did so, on average, 36 months after having stopped paying monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

12. Bally's reactivation revenue recognition policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving in the coming year and then immediately recognize most of these projected payments by improperly allocating them to past periods. Bally's reactivation revenue recognition policy was not in conformity with GAAP because use of the method enabled Bally to recognize revenue before it was earned and was realized or realizable.⁵ Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all.

13. In short, Bally violated GAAP by recognizing revenue related to the anticipated future payments before the reactivation transactions occurred. The accounting was clearly not in conformity with GAAP, and a reasonable accountant who understood Bally's accrual basis of recognizing revenue for "reactivations" would conclude that it was not in conformity with GAAP, because Bally was recognizing revenue that was not realized or realizable, and had not been earned.

14. For at least six years, E&Y had audited Bally's "reactivation" revenue recognition practices. In each of those years, E&Y provided Bally with an unqualified audit opinion.

15. Sever knew or should have known that Bally's accounting policy for reactivation revenues was not in conformity with GAAP, yet he reviewed and did not object to E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.⁶

⁵ See, e.g., Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* ("ARB 43"), Chapter 1A (1953); Accounting Principles Board Opinion No. 10, Omnibus Opinion (1966); Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1985); Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, Topic 13.A. (1999)("SAB 101").

⁶ See AICPA's Codification of Auditing Standards AU § 508, *Reports on Audited Financial Statements*, ("AU § 508").

Premature Recognition Of Initiation Fee Revenue

16. Members paid a substantial initiation fee in connection with new membership contracts. Beginning in 1997, Bally recognized initiation fee revenue over the estimated average membership life, which included an estimate for both the average initial contract period and the average renewal period. Bally computed the weighted average expected membership life to be 22 months for financed memberships and 36 months for cash memberships.

17. Bally's 1997 computations of the weighted average expected membership life were flawed. A cursory inspection of the computations would have revealed these flaws. In 1997, E&Y had checked Bally's arithmetic and suggested some minor adjustments, but failed to test whether Bally's computations produced results that were consistent with reality, and failed to determine that Bally's computation was fundamentally incorrect. The errors in Bally's estimates had the effect of understating the average membership life. As a result, Bally's member life estimates improperly accelerated revenue recognition and distorted the economic reality of Bally's business.

18. These errors continued through the relevant period. Sever knew or should have known, that by recognizing initiation fee revenue from financed contracts over 22 months, Bally was improperly recognizing revenue before it was earned and realized or realizable in contravention of GAAP, yet he reviewed and did not object to E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

Deferral Of Member Acquisition Costs

19. Bally deferred certain of its costs associated with acquiring new members and recognized such costs over the same period that it deferred initiation fee revenue.

20. GAAP requires that any costs deferred must be direct and incremental to the acquisition of a new contract or activities directly related to such acquisitions (i.e., they would not have been incurred "but for" the acquisition of the contract). Costs associated with acquiring new members are properly deferrable to the extent that they were direct and incremental to the acquisition of a new member contract, while all other costs must be expensed as incurred.⁷ Bally, however, improperly deferred certain costs that were not eligible for deferral.

21. Sever knew or should have known that Bally was improperly deferring certain member acquisition costs, but he reviewed and did not object to E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

⁷ See Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, (Dec. 1986); FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, (Dec. 1990); and SAB 101, Topic 13.A.

E&Y's Audits Were Deficient And Not Performed In Accordance With GAAS

22. E&Y's audits of Bally's reactivation revenues, initiation fee revenues, and deferred acquisition costs were deficient and not performed in accordance with GAAS. As an initial matter, Sever knew that Bally was a risky client due to, among other things, management's aggressive accounting policies.

23. E&Y prepared a memorandum in connection with the FY 2000 audit (the "2000 memo"), which concluded, improperly, that Bally's reactivation revenue accrual "does not appear to be precluded by SAB 101." The memorandum indicated that (a) members who did not pay dues after the initial contract period were barred from the gyms after a grace period, and (b) these members had no legally enforceable obligation to pay dues after the initial contract period or to reactivate their memberships. Sever reviewed and approved the memorandum even though he knew or should have known that that these facts undermined and contradicted the conclusion that the reactivation accrual "does not appear to be precluded by SAB 101." Sever should not have concluded that Bally's reactivation revenue policy was in conformity with GAAP and thus Sever failed to reasonably assess whether Bally's financial statements were presented in conformity with GAAP, as required by GAAS.

24. Sever also knew or should have known that part of the rationale contained in the 2000 memo supporting Bally's reactivation revenue policy -- that reactivation revenue was a continuation of the original contract -- was contrary to a representation that Bally had previously made to the Commission staff, in connection with its calculation of the average membership life estimate, that reactivation memberships were "in substance and in form, new contractual arrangements." Sever did not direct the engagement team to address or resolve Bally's conflicting revenue recognition treatments of reactivation memberships.

25. Initiation fee revenue was the largest component of Bally's revenue. In 1997, Bally had committed to the Commission staff that the company would periodically update its member life estimates. Contrary to that commitment, Bally failed to update its member life estimates throughout the period that E&Y remained its auditor and that Sever remained the IRP and subsequently remained involved with the Bally audit.

26. Sever knew or should have known of Bally's failure to keep that commitment. In fact, E&Y formally requested Bally to update its member life computations in 1998, 2001, and 2002, but Bally never did so. In response to E&Y's 2001 request, Bally asserted that the 1997 calculations were still "an appropriate approximation of the current historical average membership length" because the original calculation constituted a "35-year historical average." In fact, the 1997 calculation did not constitute a 35-year historical average, but reflected an average from a much smaller pool of data. Sever knew or should have known that Bally's representations regarding the 1997 calculation were false.

27. E&Y failed to perform adequate audit procedures with regard to the renewal period estimate and the resulting amortization period.⁸ Rather, E&Y simply carried forward the

⁸ See AU § 342, *Auditing Accounting Estimates*.

1997 estimates pertaining to the average renewal period. Sever knew or should have known of E&Y's audit failures. Given the critical nature of this accounting estimate, Sever's failure to require E&Y to obtain from the Company an update or to arrive at its own independent estimate constitutes a departure from GAAS.

28. Sever also knew or should have known of Bally's arbitrary and unsupported allocation of various costs to the deferred member acquisition cost pool, but he failed to require E&Y to perform adequate audit procedures with regard to those deferred member acquisition costs.

29. Sever knew or should have known that Bally's 2001 and 2002 financial statements were not presented in conformity with GAAP, but he failed to require E&Y to qualify its opinion or issue an adverse opinion as required by GAAS.

E&Y Seeks To Reduce Its Risk: 2002-2003

30. In 2001 and 2002, a series of widely-known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. Internally, E&Y, including Sever, was communicating the dangers of retaining high risk clients, but even though E&Y identified Bally as one of its riskiest clients during the 2002 client continuance process, E&Y did not resign from Bally. Instead, E&Y tried to reduce the risk that Bally's accounting practices posed to E&Y by, among other things, insisting for the first time that Bally record the numerous accounting errors that had "historically been [placed by E&Y] on the summary of audit differences."

31. In addition, during this period, Sever was responsible for developing and implementing E&Y's initiative to identify the firm's highest risk clients. Sever, working with the area PPDs, developed a list of the approximately 18 highest risk accounts. These accounts, including Bally, were identified as National Focus Accounts for Americas Executive Board attention.

32. As a result of the implementation of the "Focus Accounts" program, Bally, its accounting, and its retention as an E&Y client came under scrutiny from E&Y regional and national management. E&Y's National Office, including Sever, actively participated in events relating to Bally's critical accounting issues. From July 2002 through March 2003, E&Y, including Sever, had numerous internal communications and meetings regarding the risks posed by Bally generally, as well as particular risky accounting issues, including, among other things, Bally's revenue recognition estimates. Bally was the subject of a series of meetings with E&Y management, including Sever, and Bally was placed on the list of National Focus Accounts. Despite his position as National Director of Area Professional Practice and his lack of any formal role on the Bally's audits, Sever was heavily involved with Bally's accounting issues in 2002 and 2003.

**Sever Knew Or Should Have Known Bally Made False And Misleading Disclosures
Regarding A \$55 Million Charge In Fiscal Year 2002**

33. As of 2002, Bally's allowance for doubtful accounts ("ADA") had long been on E&Y's list of concerns regarding aggressive accounting. Bally's estimate of the ADA was another area in which management's estimates appeared aggressive. Year in and year out, from 1997 through 2002, Bally consistently used a 41% reserve rate, despite changes in the economy and in market conditions. The resulting ADA was always at the low end of the range that E&Y had deemed to be reasonable.

34. During the third quarter of 2002, Sever and others at E&Y determined that Bally's collections had deteriorated substantially, and they advised Bally that it needed to increase its ADA in order to cover the shortfall resulting from the deteriorating collections. Sever also met with both Bally's CFO and CEO to discuss the need to increase Bally's bad debt allowance. Bally insisted that no change be made to the ADA until the fourth quarter to allow it time to obtain waivers of debt covenants provisions from Bally's lenders.

35. During the fourth quarter of 2002, Bally agreed to increase its ADA by \$55 million and ultimately presented it as a "special charge" in Bally's year-end financial statements. In its 2002 Form 10-K, Bally made false and misleading disclosures regarding the reasons for the charge, and Sever knew or should have known that the disclosures were improper. The only reason for the charge cited in the Form 10-K was that Bally's estimation was based on an accelerated monetization scenario which would result in collecting less than book value. No mention was made of the deterioration of the collectability of Bally's accounts receivable portfolio, which had been identified by E&Y as requiring Bally to take a charge.

36. The \$55 million special charge virtually eliminated Bally's 2002 earnings. Sever knew or should have known that Bally's disclosures failed to disclose accurately the reasons for the "special charge," yet he did not object to E&Y's issuance of an unqualified audit opinion upon Bally's 2002 financial statements in violation of GAAS.⁹ Sever also failed to require E&Y to tell Bally's Audit Committee about Bally's false and misleading disclosures.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Year 2003

37. In March 2003, after the 2002 audit had concluded but before the company had filed its 2002 Form 10-K, E&Y, including Sever, contemplated resigning from the Bally engagement "due to risk issues." E&Y decided against resigning in favor of staying on and reducing its risk.

38. Following the decision to remain as Bally's auditor, a new E&Y audit engagement partner rotated on to the Bally engagement in April 2003. The new engagement partner, who was selected because he was experienced and capable of delivering tough messages, was instructed to "fix this situation to reduce the firm's risk."

⁹ See AU § 431, *Adequacy of Disclosure in Financial Statements*; AU § 508.

Recognition Of Reactivation Revenue

39. After the new engagement partner joined the Bally audit team, he reviewed E&Y's prior analysis of Bally's accounting for reactivations, the 2000 audit file memo that Sever had approved, and raised a number of questions challenging its reasoning. The new engagement partner consulted with Sever and the former engagement partner, but the new engagement partner remained concerned about whether Bally's reactivation revenue recognition policy was in conformity with GAAP.

40. In June 2003, Bally was in the process of refinancing its bank debt through a private debt offering, to be followed by a public exchange offering. In connection therewith, Bally needed E&Y to provide a comfort letter to the underwriters and a consent regarding Bally's use of E&Y's unqualified audit opinion relating to the 2002 audit. E&Y, including Sever, told Bally that unless it stopped accruing reactivation revenue, E&Y would not provide those documents, which left Bally with no real alternative but to agree to stop accruing reactivation revenue.

41. Even though a few months earlier E&Y had issued an unqualified audit opinion regarding Bally's 2002 financial statements that included its reactivation revenue accrual, in a June 16, 2003 meeting, E&Y, including Sever, demanded that Bally change its reactivation revenue recognition policy. Initially, Sever suggested that Bally write off the reactivation accrual in that quarter or over the next several quarters. Neither alternative was in conformity with GAAP: the \$20.3 million reactivation accrual could not be written off in one quarter because a material error requires a restatement under Accounting Principles Board Opinion No. 20, *Accounting Changes*; and the \$20.3 million was material to Bally's income statement. Similarly, spreading of the write-off of an error over several quarters is not in conformity with GAAP.

42. In the same June 16, 2003 meeting, the issue of a preferability letter was then raised. That same day, after Sever and other senior E&Y partners consulted with the head of E&Y's National Office, E&Y agreed to provide Bally with a preferability letter stating that the proposed change in reactivation revenue recognition policy to a cash basis was a more preferable method of accounting for reactivation revenues.

43. In August 2003, Bally sent E&Y a written request for approval of the proposed change in accounting. Sever reviewed and approved Bally's written preferability request before E&Y issued its final preferability letter.

44. Sever knew or should have known that Bally's change in accounting for reactivation revenues was not, in fact, a change in accounting principle, but rather was a correction of an error that required a restatement because Bally's original accrual methodology was not in conformity with GAAP. A change in accounting can only be used to move from a GAAP-compliant accounting methodology to a more preferable GAAP-compliant accounting methodology; errors in previously issued financial statements cannot be corrected through an

accounting change.¹⁰ Bally's 2003 financial statements, therefore, improperly included a cumulative effect charge of \$20.3 million associated with its change in accounting principle when its prior years' financial statements should have been restated. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, yet Sever did not object to E&Y issuing an unqualified audit opinion on Bally's 2003 financial statements in violation of GAAS.

Recognition Of Initiation Fee Revenue

45. For the year-end 2003 audit, E&Y and Sever turned their attention to Bally's other accounting estimates, including the member life estimates used in determining the amortization period of initiation fees that Sever knew or should have known were not in conformity with GAAP. Sever knew that E&Y had repeatedly identified as a "critical accounting policy" Bally's initiation fee revenue recognition methodology. Given the concerns about fraud perpetrated by means of accounting estimates, for the 2003 audit, E&Y planned to focus its attention on Bally's membership revenue recognition methodology.

46. E&Y's audit planning reflected its awareness that Bally had failed to update its member life estimate since 1997 and that the company had ignored both its commitment to the Commission staff to do so and E&Y's repeated recommendations to do so. Consistent with its audit planning concerns about Bally's aggressive estimates and the risk of financial fraud, E&Y requested that Bally provide support for the member life estimate for the 2003 fiscal year. Despite repeated efforts to obtain the information, E&Y never received the requested support.

47. Rather than continuing to press Bally for support for its complex accounting estimates, at a meeting on January 25, 2004, E&Y, including Sever, encouraged Bally to change its complex accounting methods, including initiation fee revenues. E&Y prepared an agenda for the January 2004 meeting with Bally; four of the five agenda items related to identified audit adjustments that subsequently totaled approximately \$260 million.

48. At the January 2004 meeting, E&Y, including Sever, notified Bally that it would have to take a charge relating to new accounting guidance that Bally had failed to implement during the third quarter of 2003. E&Y also identified three adjustments that Bally would have to book. E&Y made clear that the new accounting guidance would require Bally to apply a modified cash basis of accounting to some of its contracts. As Bally and E&Y discussed the proposed change, Bally's CFO proposed adopting a modified cash basis of accounting for all of the company's membership contracts. Sever knew or should have known that the change to a modified cash basis for the rest of Bally's revenue recognition accounting would have the effect of allowing Bally to avoid or at least reduce the significance of some of the charges E&Y had identified. The proposed changes would also subsume some of the prior audit failures relating to initiation fee revenues. Bally changed its accounting and Sever reviewed and did not object to E&Y's issuance of a preferability letter that he knew or should have known enabled Bally to improperly avoid a restatement with respect to initiation fee revenue.

¹⁰ See APB Opinion No. 20, *Accounting Changes*.

49. Bally's change from accrual accounting to a modified cash basis of accounting was not, in fact, a change in accounting principle, but rather involved a correction of an error that required a restatement because Bally's implementation of the deferral method for recognition of initiation fee revenue was not in conformity with GAAP. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, but Sever nonetheless reviewed and did not object to E&Y's issuance of an unqualified audit opinion on Bally's 2003 financial statements in violation of GAAS.

E&Y's Audit Was Deficient And Not Performed In Accordance With GAAS

50. E&Y's 2003 audit was deficient and not performed in accordance with GAAS. E&Y and Sever failed to obtain sufficient competent evidential matter to support an opinion that Bally's estimates, including the average member life estimates, were reasonable.¹¹ E&Y told Bally's audit committee that GAAS prescribed certain "mandatory procedures," including: "reviewing accounting estimates for biases that could result in material misstatement due to fraud, including retrospective review of significant prior year estimates. . . ."

51. E&Y and Sever also did not follow up on evidence that Bally's average member life estimates were biased and unsubstantiated.

52. The change in accounting to a modified cash basis resulted in Bally recording a cumulative effect adjustment ("CEA") of more than \$441 million, which was much more than the effect of the identified audit adjustments referred to above, but allowed Bally to provide a positive explanation for the effect. Given that a significant amount of the CEA related to how Bally had amortized the initiation fees over a period of less than two years, Sever should have questioned how two supposedly GAAP-compliant methodologies resulted in such a material disparity in earnings. Nonetheless, he failed to do so. If he had followed up, Sever would have determined that Bally's prior calculation of the member life estimates was not reasonable and the Company's straight-line amortization of the financed membership initiation fees over a 22-month period was not in conformity with GAAP.

53. Just as E&Y's issuance of a preferability letter with regard to the change in accounting for reactivation dues was improper, so too was its issuance of a preferability letter with regard to the change to a modified cash basis for initiation fees. By the time E&Y began the 2003 audit, Sever knew or should have known of the issues associated with the average member life estimate that required vigorous audit procedures, yet he failed to respond adequately.

54. Sever knew or should have known that Bally's 2003 financial statements were not presented in conformity with GAAP, and he failed to require E&Y to qualify its opinion or issue an adverse opinion as required by GAAS.

¹¹ See AU § 230, *Due Professional Care*; AU § 326, *Evidential Matter* ("AU § 326"); AU § 333A, *Management Representations*.

Sever Knew Or Should Have Known Bally Made Improper Disclosures Concerning The Lack Of Disagreements And Reportable Events With E&Y

55. When an auditor to a public company resigns, Item 304 of Regulation S-K requires both the company and the auditor to disclose whether any "disagreements" or "reportable events" occurred in the two most recent fiscal years or any subsequent interim period. The term "disagreements" is interpreted broadly, to include any difference of opinion concerning any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures which (if not resolved to the former auditor's satisfaction) would have caused it to make reference to the issue in its audit opinion. The term "reportable events" includes events such as the auditor having advised the company that it questions the reliability of (1) the company's financial statements, (2) management's representations, or (3) the company's internal controls. Item 304 also requires the former auditor to file a letter stating whether it agrees with the company's Item 304 disclosures and, if not, stating the areas of disagreement.

56. In March 2004, Sever, and other senior E&Y partners, including the Engagement Partner and the IRP, participated in a meeting during which they decided to resign as Bally's auditor. A memorandum prepared by the Engagement Partner for the meeting, and given to Sever and others to review and comment prior to the meeting, identified reasons for resigning, including the engagement team's distrust of Bally's senior financial management; its concerns regarding the company's internal controls and accuracy of accounting records and the accuracy of management's accounting estimates. In addition, Sever knew of contentious discussions with Bally's management over various issues, including E&Y's demand that Bally end its practice of recognizing revenue from reactivations that Bally projected would occur in the future.

57. Following the internal E&Y meeting, E&Y advised Bally's Audit Committee that it would resign from the engagement because of concerns regarding management's tone, the company's need to demonstrate more concern regarding internal control issues and the accuracy of its accounting records, and the accuracy of management's estimates.

58. In Bally's 2003 Form 10-K disclosure, the Company announced E&Y's resignation but represented that there were no disagreements or reportable events. Similarly, E&Y filed a letter with the Commission stating that it agreed with Bally's statements there had been no disagreements or reportable events with Bally's management.

59. The events described above reflect "disagreements" and "reportable events" that were required to be disclosed under Item 304 of Regulation S-K. Sever knew or should have known that these disagreements and reportable events were required to be disclosed, but did not object to the representations in Bally's 2003 Form 10-K stating there had been no "disagreements" or "reportable events;" or prevent E&Y from issuing a letter agreeing with the Company's Item 304 disclosures.

Violations

60. Section 17(a)(2) of the Securities Act prohibits obtaining money or property by means of untrue statements of material fact or misleading omissions of material fact in the offer or sale of securities. Section 17(a)(3) of the Securities Act prohibits engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities. Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Establishing violations of Section 17(a)(2) and 17(a)(3) does not require a showing of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

61. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder require all issuers with securities registered under Section 12 of the Exchange Act to file annual, current and quarterly reports on Form 10-K, Form 8-K and Form 10-Q, respectively. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file these periodic reports includes the obligation that they be complete and accurate in all material respects. *See, e.g., SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889, 893 (N.D. Tex.), *aff'd mem.*, 505 F.2d 733 (5th Cir. 1974). No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20. *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998).

62. Section 13(b)(2)(A) of the Exchange Act requires issuers to “make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.”

63. Bally violated Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder by, among other things, prematurely recognizing income and improperly deferring costs which resulted in its books and records being false, failing to maintain accurate books and records, and including misleading financial statements and information in annual, quarterly and current reports filed with the Commission in connection with fiscal years 2001 through 2003.

64. Sever was a cause of and aided and abetted Bally's violations. For each of the years 2001-2003, Sever reviewed and did not object to E&Y's issuance of audit reports containing unqualified opinions stating that E&Y had conducted an audit of the company's annual financial statements in accordance with GAAS and that Bally's financial statements were presented in conformity with GAAP. These audit reports were included in Bally's Forms 10-K for 2001-2003. However, Sever knew or should have known that E&Y's audit reports were false and misleading because E&Y failed to conduct its audits in accordance with GAAS and Bally was engaged in accounting practices and disclosures that were not in conformity with GAAP.

65. In auditing Bally's accounting practices relating to reactivation revenue, initiation fee revenue and deferred acquisition costs, Sever failed under GAAS to exercise due professional care and skepticism, failed to ensure that E&Y obtained sufficient competent evidential matter, and substituted managements' representations for competent evidence supporting the accounting. Sever failed to insist that Bally provide support for certain of these estimates, nor did Sever require that the engagement team perform sufficient audit procedures to test and determine whether these accounting actions resulted in appropriate recognition of revenue. Had he done so, he would have reasonably determined that these accounting practices were not in conformity with GAAP.

66. Despite these accounting and audit failures, and in further violation of GAAS, Sever did not require E&Y to express a qualified or adverse audit opinion, or refuse by disclaimer to express any opinion at all, but instead issued audit reports that contained unqualified opinions on Bally's 2001-2003 financial statements. Sever also knew or should have known that Bally was making false and misleading disclosures such as in connection with its \$55 million special charge. Nor did Sever propose that Bally correct its improper accounting in the quarterly financial statements that E&Y reviewed during 2001-2003. Sever also did not object to E&Y improperly issuing preferability letters that allowed Bally to switch its accounting policies for reactivation revenue and initiation fee revenue instead of restating for errors relating to that accounting. Accordingly, Sever's failure to comply with GAAS was a cause of Bally's violations of Section 17(a)(2) and (3) of the Securities Act and was a cause of and aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

67. Sever also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act in connection with Bally's failure to disclose that the \$55 million special charge recorded in its FY 2002 financial statements was due to a deterioration in the collectability of the Company's receivables. Sever failed to require E&Y to report this illegal act to the Audit Committee in accordance with Section 10A(b).

Findings

As a result of the conduct described above, Sever was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and was a cause of and willfully aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. Sever also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not ensuring that E&Y brought to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the \$55 million special charge.

IV.

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

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

A. Sever cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act, and from causing any violations and any future violations of Sections 10A(b), 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder;

B. Sever is denied the privilege of appearing or practicing before the Commission as an accountant pursuant to Rule 102(e)(1)(iii);

C. After 3 years from the date of this order, Sever may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Sever's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Sever, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Sever, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in Sever's or the firm's quality control system that would indicate that Sever will not receive appropriate supervision;

(c) Sever has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Sever acknowledges his responsibility, as long as Sever appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

D. The Commission will consider an application by Sever to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will

consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Sever's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary