

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of	:	
	:	
KEVIN HALL, CPA, and	:	INITIAL DECISION
ROSEMARY MEYER, CPA	:	January 15, 2008

APPEARANCES: Robert W. Pommer, III, Matthew B. Greiner, and H. Michael Semler
for the Division of Enforcement, Securities and Exchange Commission

Miles N. Ruthberg, Peter W. Devereaux, Jamie L. Wine,
William R. Baker, III, David A. Becker, and Kevin H. Metz of
Latham & Watkins, LLP, for Respondent Kevin Hall, CPA

Gary F. Bendinger, Wesley D. Felix, and Yolanda Hawkins-Bautista of
Howrey, LLP, for Respondent Rosemary Meyer, CPA

BEFORE: Carol Fox Foelak, Administrative Law Judge

SUMMARY

This Initial Decision clears CPAs Kevin Hall (Hall) and Rosemary Meyer (Meyer) of charges of improper professional conduct in their audit of the 1999 financial statements and interim review of the second quarter 2000 financial information of US Foodservice, Inc. (USF).

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission or SEC) initiated this proceeding on February 16, 2006, by an Order Instituting Proceedings (OIP). The proceeding was authorized pursuant to Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e) (Rule 102(e)).

The undersigned held eleven days of hearings in Washington, D.C., on July 9 through 20 and October 5, 2007. The Division of Enforcement (Division) called ten witnesses from whom

testimony was taken, including an expert witness. Respondents Hall and Meyer testified in their own cases and called an expert witness. Numerous exhibits were admitted into evidence.¹

The findings and conclusions in this Initial Decision are based on the record. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91 (1981). Pursuant to the Administrative Procedure Act,² the following post hearing pleadings were considered: (1) the Division's September 14, 2007, Proposed Findings of Fact and Conclusions of Law and Post-Hearing Brief; (2) Respondents' September 14, 2007, Proposed Findings of Fact and Conclusions of Law; (3) Respondent Hall's September 14, 2007, Post-Hearing Brief; (4) Respondent Meyer's September 14, 2007, Post-Hearing Memorandum of Law; (5) the Division's September 28, 2007, Reply Brief; (6) Respondent Hall's September 28, 2007, Reply Brief; and (7) Respondent Meyer's September 28, 2007, Reply Brief. All arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision were considered and rejected.

B. Allegations and Arguments of the Parties

Hall and Meyer are charged with improper professional conduct, Hall as engagement partner, and Meyer as senior manager, within the meaning of Rule 102(e), in connection with the audit of the financial statements of USF for its 1999 fiscal year and with the interim review for the second quarter of its fiscal year 2000. Specifically, the OIP alleges that Respondents failed to comply with Generally Accepted Auditing Standards (GAAS) in the 1999 audit because they failed to uncover a fraudulent scheme to overstate USF's operating income.³ Concerning the second quarter review, the OIP alleges that they allowed USF to mischaracterize certain payments it made in connection with a supply contract. The Division urges that Hall and Meyer be denied the privilege of appearing or practicing before the Commission as accountants for a period of five years. Respondents argue that they did not engage in improper professional conduct and ask that the proceeding be dismissed.

II. FINDINGS OF FACT

¹ Citations to the transcript of the hearing will be noted as "Tr. ____." Citations to exhibits offered by the Division and Respondents will be noted as "Div. Ex. ____" and "Resp. Ex.____," respectively. Many of the Division's exhibits are identical to Respondents' exhibits. These will be noted as "Div. Ex. ____ (Resp. Ex.____) [at KPMG ____]."

² See 5 U.S.C. § 557(c).

³ GAAS are the standards prescribed by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) for the conduct of auditors in the performance of an examination of management's financial statements. See SEC v. Arthur Young & Co., 590 F.2d 785, 788 n.2 (9th Cir. 1979). The ten GAAS are further defined or interpreted by Statements on Auditing Standards (SAS), which are codified in the Codification of Statements on Auditing Standards, as "AU § ____." Div. Ex. 228 at 4.

A. USF and Respondents

1. USF

USF is a broad-line distributor of foods, that is, it purchases foods from various vendors and sells to restaurants, institutions, and the like. Tr. 215. The company has been known as USF since 1997, following several mergers or acquisitions. Tr. 214, 487-88, 493, 604. During the time at issue, its fiscal year ended on the closest Saturday to June 30. Tr. 216. Thus, the 1999 fiscal year ran from June 28, 1998, to July 3, 1999. Tr. 962.

USF was acquired by Royal Ahold, a much larger company, in April 2000. Tr. 414-15, 603-04. During the time at issue, USF's independent public accountant was KPMG LLP (KPMG), which audited its financial statements for fiscal year 1999, as well as for 1997 and 1998. Tr. 1685, 2010. Hall and Meyer worked together on the 1997 and 1998 audits, as well as on the 1999 audit at issue. Tr. 1979, 2001. After the Royal Ahold acquisition, Deloitte and Touche (Deloitte) became the auditor. Tr. 1818.

Mark Kaiser (Kaiser) was USF's vice president of sales and marketing. He was convicted, based on his wrongdoing at USF, of one count of securities fraud, four counts of false filings with the SEC, and one count of conspiracy and sentenced to seven years of imprisonment, two years of supervised release, and a \$50,000 fine. United States v. Kaiser, 1:04-cr-00733-TPG (S.D.N.Y. May 18, 2007). Timothy Lee (Lee), who reported to Kaiser, was the executive vice president over USF's purchasing group. Tr. 218, 487-89. Lee is being prosecuted for his wrongdoing at USF: pursuant to a July 23, 2004, cooperation agreement with the United States Attorney's Office for the Southern District of New York, Lee pleaded guilty to four felony charges of securities fraud, conspiracy, and making materially false and fraudulent statements to the United States Government. Tr. 659-62; Resp. Ex. 1072; United States v. Lee, 1:04-cr-00712-PKC (S.D.N.Y.). He awaits sentencing. Tr. 662.

2. Hall

Hall has been an auditor for thirty-one years and has been a partner at KPMG since 1984. Tr. 1664, 1667-68. He has never been sued regarding his auditing work. Tr. 1663-64. He is an active member of the American Institute of Certified Public Accountants (AICPA) and the Maryland Association of CPAs, having served on and chaired the latter's ethics committee for several years. Tr. 1673-74. He led the team of KPMG auditors as engagement partner in charge of KPMG's audit of the 1999 financial statements of USF.⁴ Tr. 1664. That is, he drew the conclusions with respect to the promotional allowances at issue and signed the opinion on the USF financial statements on behalf of KPMG. Tr. 1664-65, 1670. Up to the present, Hall has been the engagement partner on more than 200 engagements and the concurring review partner

⁴ The engagement partner plans the engagement, is responsible for assigning the tasks that the staff are going to carry out, for supervising the work, and then for ultimately drawing the conclusion with respect to the financial statements taken as a whole. Tr. 1140-41, 1669.

on at least fifteen engagements.⁵ Tr. 1669-71. In 2005, after the events in question, KPMG promoted him to SEC reviewing partner, qualified to be a concurring partner on public company engagements; about 130 of 800 audit partners at the firm are SEC reviewing partners. Tr. 1671-73.

3. Meyer

Meyer graduated summa cum laude from the University of West Virginia in 1992 with a degree in accounting. Tr. 1985-86. She joined KPMG in July 1992 in the audit practice in the Baltimore office, where she has remained. Tr. 1987-89. After passing the requisite examinations, she became a CPA in 1993. Tr. 1990. She has never been disciplined or sanctioned by any professional association, been the subject of a complaint, or been sued regarding her professional services at KPMG. Tr. 1991-92. Meyer was the senior manager on the 1999 USF audit. Tr. 1977. Her role as next person in line after the engagement partner was to assist Hall in planning the audit, and to have responsibilities for supervision, review of work papers, evaluation of audit evidence, and keeping Hall informed. Tr. 1141, 1985. Before the 1999 USF audit she had participated in about fifty audits. Tr. 1990. In October 2003, after the events in question, she became a partner. Tr. 1988. Since then she has signed about ten to fifteen audit opinions on behalf of KPMG. Tr. 1991.

B. The Fraud at USF

It is undisputed that USF was engaged in a financial fraud before, during, and after the time at issue and that Respondents did not detect the fraud during the 1999 audit. The fraud involved USF's accounting for vendor rebates, known in the food distribution industry as promotional allowances (PA), that were paid to USF by its vendors based on purchasing volume. As described below, the fraud involved prepayments of PA income⁶ that were booked as income when received before being earned.⁷ The evidence does not disclose the size of the fraud. The fraudulent scheme was hatched by Kaiser and carried out with the knowing assistance of his deputy, Lee.

⁵ The concurring review partner is a second partner on the engagement whose role is to understand the plan the team intends to carry out and to understand the key decisions the engagement team reaches in concluding on the audit. Tr. 1670. In addition, he or she reads the financial statements to determine whether any other matters come to his or her attention. Tr. 1670-71. Any concerns the concurring partner may have must be resolved. Tr. 1671.

⁶ The OIP also referenced "entirely fictitious" PA income. However, this was not developed in the evidence of record, except in relation to the period in which cash payments were applied.

⁷ Specifically, PAs were recorded as a reduction of the cost of goods sold. Tr. 396.

USF had PA programs with large national vendors that accounted for the largest volume of USF's purchases.⁸ Tr. 491-92. For the most part, they were rebate programs based on quantities purchased times a rate per unit purchased. Tr. 1697. As a practical matter, the margin on sales of products to customers was very small, and the PAs provided profits. Tr. 512. PAs were handled in USF's purchasing department, which determined how the revenue would be recorded on the corporate books. Tr. 342-47. The accounting group, which employed several CPAs, merely performed a clerical function in regard to accounting for PAs. Tr. 339-40, 342-43, 393, 874-75, 902-04. David Todd (Todd), a CPA, headed the accounting group, and David Rowland, his subordinate, tracked PA billing and cash payments. Tr. 338-40, 874-75, 1012. Neither was aware of the fraud. Tr. 454, 458-60, 1013-17; Resp. Ex. 1002. The accounting group understood that questions about PAs should be directed to Kaiser or Lee. Tr. 360.

USF did not have PAs with so-called commodity vendors of beef, pork, poultry, and seafood; rather it used brokers, referred to as "value added service providers" (VASPs), from or through which it purchased commodities from the vendors and which billed USF for the purchases. Tr. 507. Instead, USF "sheltered" income in "buckets" in deals with these brokers: "shelter" was a mark-up over the price that USF actually paid the vendor; the amount of the mark-up was determined by USF; when USF paid for purchases based on the marked-up price, the VASP retained the extra monies and returned them to USF in lump sum payments as instructed by USF. Tr. 548-550, 775-80.

Some vendors paid PA balances monthly, based on the prior month's purchases, and others paid quarterly, after the close of a quarter. Tr. 502-03. There were also prepayments, paid by a vendor in anticipation of a future volume of purchases by USF; these arrangements were with USF's largest vendors. Tr. 490-92. USF started demanding prepayments in the mid-1990s; this was Kaiser's idea. Tr. 492-93. Kaiser ordered that prepayments be kept secret and never discussed with anyone outside the purchasing group. Tr. 668-69, 712. USF recognized all the income from the prepayments up-front rather than spreading it over the life of the contract. Tr. 275-76, 395, 495. Most prepayments were paid at the end of the fiscal year for the start of the new fiscal year, but some were paid in December. Tr. 514.

The PA account was a single account in USF's accounting system. Tr. 232-33, 265, 1716. The PA account consisted of accrued unbilled earnings and outstanding billed receivables; it affected several different parts of USF's financial statements, including the cost of goods sold and marketing costs on the income statement, and cash and accounts receivable on the balance sheet. Tr. 1716-17. USF accrued PA income monthly and reconciled it twice a year, with more emphasis on the end of the year, when USF relied on its vendors to confirm the amount of product purchased and the amount of PA income earned. Tr. 2073-74. That was referred to as the billed component, and the accounting group would generate invoices that would be sent to the vendors. Tr. 2073-75. The remaining amount was referred to as unbilled. Tr. 2073. The vendors did not pay PAs off USF's invoices; they paid off their own systems. Tr. 2075.

⁸ The company also had division level local programs with local vendors. Tr. 1697-98. The PA program at issue in this proceeding is the corporate level national program negotiated and controlled at headquarters by Kaiser. Tr. 1698.

During the time at issue USF tracked PAs manually. Tr. 347-48, 498-99. Accounting and purchasing information related to PAs resided on twenty different information systems that did not flow into one general ledger, a situation related to the growth of the company through acquisitions.⁹ Tr. 1710, 1997-98, 2074. USF's information systems did not easily facilitate consolidated purchasing activities. Tr. 2113. Thus, USF relied on its vendors to tell USF how much they owed for PAs. Tr. 499. In December and June, USF called the vendors, asked them how much they owed, and urged them to send it in. Tr. 505-06. USF attempted to extract additional money from vendors as well. Tr. 506, 546. USF's policy was to use any payments to pay down the oldest balances. Tr. 225, 262-63, 393, 503, 538-39, 996-97. PA income was accrued on an aggregate basis, based on an estimate based on historical purchases; Lee, with others, calculated the estimates. Tr. 344-47, 499-500; Div. Ex. 8 (Resp. Ex. 643). Adjustments provided by Kaiser, always upwards and in round numbers, followed at the end of USF's monthly reporting periods. Tr. 345-47, 353-55, 393, 427, 1698-99; Div. Ex. 8 (Resp. Ex. 343). Without the adjustments, USF would not have met analysts' consensus earnings per share expectations. Tr. 355-57. At the time of the Royal Ahold acquisition there was a substantial, \$75-125 million, write-off of PA receivables as uncollectible. Tr. 416, 434-35, 479-80, 605-06. However, USF did not restate its 1999 financial statements. Tr. 483.

In December 1998 and June 1999, Kaiser instructed Lee to make a list of outstanding PA billings, send it to Gordon Redgate (Redgate) of Private Brands, a VASP, or food broker for canned groceries, that had a "bucket" of USF's "shelter" and instruct him to issue checks to retire the balances of the vendors, which in fact had no relationship with Private Brands. Tr. 551-59, 572-77; Div. Exs. 99, 100. Redgate complied, providing a series of checks that were actually returning USF's "shelter" but that appeared to be PA payments on behalf of the vendors. Tr. 783-804, 834-35; Div. Exs. 31, 32, 58, 62, 64, 65, 71, 72, 74, 75, 107, 110. A similar process was followed with VASP Frozen Farms. Tr. 579-86. Additionally, Kaiser was concerned that an \$18.5 million prepayment from Puritan would draw auditors' attention in USF's cash reports, so Lee asked Redgate to take receipt of the monies and send it back to USF in several smaller checks. Tr. 697-99.

⁹ The general ledger is the main financial record from which the financial statements are summarized and extracted. Tr. 2077.

1. Processing of PA Checks

Dorothy Ware has worked for USF or its predecessors for eighteen years. Tr. 213. During the time at issue, in 1998 and 1999, she worked in the purchasing group, where her primary responsibility was to receive PA checks and deposit them in the bank. Tr. 214-15, 219, 902-04. If she had a question about a particular check, she would direct it to the product group manager (PGM) within the purchasing group who had responsibility for the type of product covered by that check. Tr. 219. She received the checks in the mail, from a broker, or from a USF executive. Tr. 217. She processed from five to more than 100 PA checks a day. Tr. 217. On receiving a check, she would apply it to the vendor's oldest open account receivable. Tr. 219, 225, 227, 393, 996. She would note the invoice[s] to which the check was to be applied on its remittance advice, if one was attached to the check; otherwise she attached the check to a plain sheet of paper and noted the information on the paper. Tr. 220-21. If the vendor had indicated an inconsistent purpose, she would consult her supervisor or a PGM and would likely be told to apply it to the oldest PA account receivable balances anyway. Tr. 227. If there was not an outstanding invoice to which the check could be applied, she wrote "billed" on the remittance advice and sent it to accounting, which would create an invoice for the amount of the check on the same day. Tr. 239-44, 393, 875-76, 948-49, 996. She would deposit the check after receiving an invoice from accounting.¹⁰ Tr. 240.

2. Secrecy, Obfuscation, and False Documentation

Kaiser's scheme included steps to obfuscate the application of cash receipts and conceal the prepayments. He maintained the manual tracking system to allow "flexibility" so that a vendor's cash payment that was not tied to a specific bill could be booked to retire a balance of another vendor. Tr. 500-01. Kaiser kept PA contracts that contained prepayment terms secret from anyone outside the purchasing group; instead, auditors were shown "term sheets" – summaries of the contracts that omitted or mischaracterized prepayment provisions.¹¹ Tr. 668-75, 712, 1725, 2013; Div. Ex. 81 (Resp. Ex. 715); Resp. Ex. 5 at AH0051891, Resp. Ex. 48.

¹⁰ Before depositing a PA check, she would make three copies of the check and remittance advice or other notes. Tr. 219. One copy went to the PGM and one went to accounting, along with the deposit slip, with a breakdown of how much money went from the checks to different accounts, 22400 being the PA account. Tr. 232, 234. She retained a copy and associated it with the invoice or invoices to which it had been applied after adding it to a database she kept. Tr. 232-34.

¹¹ Before the hearing commenced, the Division represented, in its April 20, 2007, Pre-Hearing Memorandum of Law (at 20 n.11), June 28, 2007, Memorandum in Response to Respondents' Motion to Strike and Motion for Partial Summary Disposition (at 1-2), and at the July 6, 2007, prehearing conference (at 10-23), that it would not attempt to prove that Respondents actually reviewed contracts containing prepayment terms, as alleged in the OIP at ¶¶ 4 (second sentence), 29 (item 3), 38 (last sentence), and 60-68. Accordingly, and consistent with Kaiser's policy of keeping the contracts secret from anyone outside the purchasing group, it is found that Respondents did not review or have access to contracts containing prepayment terms.

On learning that the auditors questioned a remittance advice from a particular prepayment that used the term “advance,” Kaiser ordered that vendors be told that their remittance advices should not use the term “advance.” Tr. 527-30. Also, remittance advices that suggested prepayment were detached from checks. Tr. 221, 539-40. Letters, drafted by Kaiser, were obtained from vendors that appeared to state that payments had been earned and that could be shown to the auditors without alerting them to the fact that the payments were prepayments but that gave comfort to USF and the vendors that their contractual obligations concerning prepayments were unchanged. Tr. 529, 539, 590-95, 598-603, 694-97; Div. Exs. 80, 83, 84 (Resp. Exs. 714, 717, 718); Resp. Ex. 399 at AH0529576.

For the audit at issue, Respondents decided to test a sample of PA receivables through confirmation letters. Tr. 2088. Kaiser and Lee took steps to corrupt the test; they identified individuals who would be willing to sign confirmation letters containing numbers that were not accurate. Tr. 610-11. The recipients were told by USF that they would receive confirmation letters, to sign and return them, and not to worry about inaccurate information; they would not actually have to pay the balances they would be confirming. Tr. 612, 678-80. Through the efforts of Kaiser and Lee, a list of vendor contacts was created for the thirty-five accounts that Respondents selected for confirmation, consisting of individuals associated with brokers or others with whom they did business who would sign false confirmations and avoiding individuals who would refuse to do so. Tr. 611-43, 675-94; Div. Ex. 116 (Resp. Ex. 746). Some individuals cooperated knowingly, for example, Fred Peirce (Peirce)¹² and Redgate. Tr. 744-69, 809-17, 825-34. Another signatory, Timothy McLellan, was tricked by his supervisor into signing what he believed was a routine personnel document but was actually a confirmation. Tr. 1644-56. A similar process had been followed for the 1998 audit. Tr. 644-48, 805-09; Div. Ex. 165 (Resp. Ex. 754). Some 1998 audit confirmation recipients did not sign the confirmation letters directed to them; thereafter USF did not indicate these individuals as contacts to whom confirmation letters should be sent. Tr. 649-51; Div. Ex. 168 (Resp. Ex. 757). The arrangement with Redgate included layers of deception: the confirmation letters were directed not only to Redgate but to two of his employees at different business names and addresses; Redgate forged the signature of one and had another person forge the signature of the second.¹³ Tr. 805-17, 825-34, 857-70; Div. Ex. 116 (Resp. Ex. 746). Redgate continued signing false confirmations after the time at issue. Tr. 836. He is being prosecuted for his wrongdoing: pursuant to a March 7, 2005, cooperation agreement with the United States Attorney’s Office for the Southern District of New York, Redgate pleaded guilty to one felony charge of conspiracy. Tr. 817-18, 836-38; Resp. Ex. 1081; United States v. Redgate, 1:05-cr-00064-DAB (S.D.N.Y.).

¹² Peirce was asked by his employer, Peter Marion, with whom USF did business, to sign, and he complied. Tr. 627-29, 745-48, 762-69. Peirce has not been charged criminally. Tr. 770. Marion is awaiting sentencing on charges arising out of his involvement with the USF PA program. United States v. Marion, 1:04-cr-00523-VM (S.D.N.Y.).

¹³ The arrangement with Redgate continued on a larger scale after the Royal Ahold acquisition. Tr. 836. Redgate has pleaded guilty to one count of conspiracy, pursuant to a cooperation agreement; he awaits sentencing. Tr. 817-18, 836-38; Resp. Ex. 1081.

Kaiser and Lee continued the same deceptive course of action after the acquisition by Royal Ahold and Deloitte became the auditor of USF. Tr. 716-17, 723-26, 736-37, 741, 836. In fact, the size of the PA program increased. Tr. 427, 836. In February 2003, during the audit for 2002 (the fiscal year was now the same as the calendar year), a vendor that received a confirmation letter, Heritage Bag, answered truthfully, providing details of a \$2 million prepayment, and the scheme unraveled.¹⁴ Tr. 652-58.

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

Hall and Meyer started planning USF's fiscal 1999 audit early in calendar year 1999. Tr. 1690, 2057. Their historical knowledge from their 1998 and 1997 audits informed their planning of, and judgments during, the 1999 audit. Tr. 1687-88, 2010.

To prepare for the 1997 audit, Meyer studied the work papers of the predecessor auditor, Price Waterhouse, and USF's SEC filings, talked with company management, accountants, and other people in the business, and discussed USF with Hall. Tr. 1728-29, 2010-11. Hall had prior auditing experience in the food industry and with rebate programs. Tr. 1685-86. Respondents walked through key transaction cycles with company personnel to understand how transactions are ultimately accounted for and recorded in the financial statements. Tr. 1690-91. Management told them there were no formal written contracts with the vendors, which is what the prior auditor had been told. Tr. 2013. They discussed with CFO Gerry Megas (Megas) and other USF accountants how PA income should be accounted for under Generally Accepted Accounting Principles (GAAP)¹⁵; management clearly understood that income that was recognized must be earned. Tr. 2014. USF was accounting for its PA income as if it had all been earned during 1997, and Respondents were told there were no prepayments of any amounts that had not been earned. Tr. 2014. As KPMG required for the first year of a public company audit, there was an in-depth review by the SEC reviewing partner, who concurred in Respondents' conclusions in that audit. Tr. 2015-16. By 1998, the company had grown through acquisitions, adding more complexity and increasing the PA numbers. Tr. 2016-17. Respondents added more procedures, primarily confirmations. Tr. 2017-18.

¹⁴ In pleadings, Respondents indicate that Deloitte uncovered the fraud through information it received in an unrelated audit of Sweetheart Cup. However, there is no evidence in the record concerning Deloitte's audit of Sweetheart Cup. Nonetheless, there is no dispute that 2003 was the year in which the fraud was uncovered. By that time SAS No. 99, which essentially requires the auditor to assume the client engaged in fraud with regard to revenue recognition and requires additional procedures to make it more likely that fraud will be detected, had been issued. SAS No. 99 was issued in 2002 and was effective for audits of calendar year 2003, but auditors could apply it earlier.

¹⁵ GAAP are the basic postulates and broad principles of accounting pertaining to business enterprises. These principles establish guidelines for measuring, recording, and classifying the transactions of a business entity. See SEC v. Arthur Young & Co., 590 F.2d at 789 n.4.

By 1999, Hall and Meyer had confidence in the representations of management; they found that management knew the business well and understood the financial information. Tr. 2038. The accounting staff, which included a number of CPAs, understood the accounting and financial reporting requirements; USF prepared its own financial statements. Tr. 1687, 2038. Hall's confidence in management representations was bolstered by past representations that turned out to be correct. Tr. 1687. Hall observed that an auditor who cannot rely on management's integrity cannot do the audit. Tr. 1688.

USF had grown significantly from 1997 to 1999 through a merger. Tr. 1689. As they had in 1997 and 1998, Respondents gained an understanding of USF's key transaction cycles of revenue, the operating costs of the entity, PAs, and payroll by walking through them with company personnel to understand how transactions were accounted for and recorded in the financial statements. Tr. 1690-91. Concerning the overall control environment, the CEO, Jim Miller (Miller), was a seasoned food service industry executive, USF had an active and independent board of directors, and members of the audit committee were financial experts. Tr. 1691-92. Also, USF had a code of conduct, and senior management had to answer questionnaires concerning their compliance with it, which was uncommon then, before the Sarbanes-Oxley Act of 2002. Tr. 1692.

In 1999, using KPMG's form, WP-511, "Consideration of Fraud in a Financial Statement Audit," that tracked then-applicable Statement on Auditing Standards (SAS) No. 82 and AU § 316,¹⁶ Hall and Meyer identified promotional income and receivables, in the context of a lack of integrated information systems, as risk factors. Tr. 1701-05; Resp. Ex. 110 at 182, Resp. Ex. 560. Their response to the fraud risk factor was to review promotional income, receivables, and collection trends and corporate arrangements and selected confirmations. Tr. 1719-28; Resp. Ex. 110 at 183. In their planning memorandum, they identified promotional income and receivables as a critical audit objective. Tr. 2058; Div. Ex. 1 (Resp. Ex. 636) at KPMG00066. This was because of USF's practice of manual tracking of PAs, which afforded a "considerable degree of management judgment relating to allowance estimates, unbilled vendor receivable estimates and revenue recognition." Div. Ex. 1 (Resp. Ex. 636) at KPMG00066. The audit team for the engagement included Hall, Meyer, another manager, and six or seven staff accountants. Tr. 1677. The team spent about 3,400 hours on the audit. Tr. 1715. Meyer, rather than a less senior member of the audit team, did most of the audit work on PA income. Tr. 1716, 2053-54.

In addition to his involvement in planning the engagement, Hall assigned or approved the assignment of individual staff. Tr. 1683. He was at USF's corporate headquarters from two to four days per week from July through the completion of the engagement. Tr. 1683-84. There was some interim work at operating locations prior to year-end. Tr. 363, 1695, 1993, 1998-99. The year-end field work was at headquarters and lasted from about the middle of July through the middle of August. Tr. 1695.

¹⁶ During the time at issue AU § 316 incorporated SAS No. 82, which was later superseded by SAS No. 99.

As described above, there was an ongoing fraud at USF. Consistent with the fraud, USF's August 16, 1999, client representation letter to KPMG, signed by Kaiser, as well as USF's chief executive officer, chief financial officer, general counsel, and chief accounting officer, represented, "All amounts accrued or billed to vendors for promotional or related allowances have been recorded based on rates included in vendor contracts. In addition, all accrued billed or collected promotional income has been earned as of July 3, 1999." Div. Ex. 3 (Resp. Ex. 638) at KPMG00297. That representation was false. Tr. 721. As discussed below, Hall and Meyer conducted audit procedures designed to test USF's PA accounting. However, they did not become aware of the fraud at USF, or specifically, that USF had received prepayments of PAs that should not have been recorded as income because they had not been earned during fiscal year 1999. Tr. 1666, 1978. Thus, KPMG's opinion, that Hall believed at the time to be correct, was an unqualified opinion that the financial statements were fairly stated in all material respects in accordance with GAAP. Tr. 1665; USF's Form 10-K for the year ended July 3, 1999.¹⁷

KPMG's Completion Memorandum, signed by Respondents in August and reviewed in September 1999, describes the procedures they performed with regard to the PA account and other matters. Div. Ex. 180 (Resp. Ex. 769). The two specific procedures at issue are the audit confirmations that sought to test the billed receivable balance at 1999 year-end and the cash-receipts vouching that tested the cash collected during the year (and immediately after year-end) and applied to the 1999 and 1998 PA accounts receivable balances.

Much of the evidence focuses on six audit exceptions identified on work paper D-31 involving prepayments and applying cash receipts to the proper period. The original work paper D-31 is in evidence as Div. Ex. 18 (Resp. Ex. 653). Color copies are in evidence as Div. Ex. 17 (Resp. Ex. 652), and black and white copies as Div. Ex. 16 (Resp. Ex. 651). Citations to this evidence will be indicated as "work paper D-31."

1. Confirmations

Respondents tested thirty-five vendors' PA accounts receivable balances by sending them confirmation requests listing the balances and asking them to confirm them as earned and owed at year-end or to state that the balances were incorrect. Div. Ex. 116 (Resp. Ex. 746). All thirty-five responses confirmed that the accounts receivable amount was correct, owed, and earned in fiscal 1999. Tr. 1754, 2096; Div. Ex. 116 (Resp. Ex. 746). Respondents considered that the result of the confirmation procedure was very strong audit evidence that in fact these amounts were earned and due. Tr. 1741, 2109-10.

Respondents followed a process of selecting and preparing confirmation requests similar to that used in the 1998 audit. Tr. 2019-22. With the exception of USF's supplying the names and addresses for the contacts, the process was controlled by KPMG. Tr. 2095-96. Respondents had no reason to believe that they could not rely on the information USF provided. Tr. 2095.

¹⁷ Official notice is taken of the Form 10-K, which is in the Commission's public official records, pursuant to 17 C.F.R. § 201.323. The Form 10-K is also in evidence as Resp. Ex. 570 and, in a different, hard-copy, format as Div. Ex. 217, Resp. Ex. 795.

Their belief had been supported when 1998 confirmation recipients indicated that they were knowledgeable by returning clean confirmations to KPMG.¹⁸ Tr. 1763-64. Respondents considered this information when planning and performing confirmation procedures in 1999.¹⁹ Tr. 1754, 2101-05.

First, Respondents obtained the list of PA accounts receivable from the USF accounting staff and agreed the balance to USF's general ledger. Tr. 1745-46, 2089-90; Div. Exs. 11, 117 (Resp. Exs. 646, 747). They verified the accuracy of the list by reconciling it to the general ledger and recalculating the total through an Excel spreadsheet. Tr. 2090; Div. Ex. 11 (Resp. Ex. 646) at KPMG01979. Respondents found the overall increase in PA receivables to be consistent with USF's growth and increase in purchasing volumes. Div. Ex. 11 (Resp. Ex. 646) at KPMG01978. Then Hall met with CFO Megas, who represented that the list was accurate and the amounts were owed and earned. Tr. 1746. Hall considered Megas to be detail-oriented and a very good accountant. Tr. 1746-47. From this list Meyer selected for confirmation the thirty highest account receivable balances and selected five additional balances haphazardly. Tr. 1749, 1751, 2090-92; Div. Ex. 11 (Resp. Ex. 646) at KPMG01979. Hall reviewed and approved the list, making changes he judged appropriate. 1749, 2090-91. The thirty-five vendors were 14% of the vendor base but about 75% of outstanding billed corporate PA receivables. Tr. 1752; Div. Ex. 11 (Resp. Ex. 646) at KPMG01979.

Next, Meyer provided the list along with the specific language to be used in the letters to Rob Soule (Soule), the Vice President of Finance and USF's Chief Accounting Officer, and to Todd, the Corporate Controller, and requested that Soule provide contact information for each of the accounts and prepare the letters using KPMG's text. Tr. 1749-50, 2092-94; Div. Ex. 11 (Resp. Ex. 646) at KPMG01979. As in their 1998 audit, Respondents used positive confirmations – the recipients were asked to return the letters and indicate whether the information provided was correct or incorrect; the letters included a representation that the entire outstanding billed amount of the vendor's receivable was earned and owed prior to year-end. Tr. 1743, 1749, 2018-19; Div. Exs. 116, 165 (Resp. Exs. 746, 754). Respondents understood that Kaiser was providing the contact information. Tr. 1750, 1920, 2093-94; Div. Ex. 11 (Resp. Ex. 646 at KPMG01979). They believed it was appropriate that Kaiser provided the contact information as he was the most knowledgeable person at USF regarding the PA account, and the information necessarily came from the company's records. Tr. 1750, 2094-95. Obtaining contact information for confirmation letters from USF was consistent with other engagements and practice at the time. Tr. 1753, 2093.

¹⁸ In 1998 Hall and Meyer sent out about thirty confirmation letters; twenty-four were returned, stating that the amounts were owed and earned, and Hall and Meyer performed alternative procedures as to the others. Tr. 1742-43, 2025-30.

¹⁹ At the 1998 audit sign-off meeting Hall discussed brokers who had signed confirmations with then-CFO Lew Hay and then-CAO Megas. Tr. 1768-70; Div. Ex. 175 (Resp. Ex. 764). Hay had advised that they could rely on Redgate and Larry Stone and that he deemed them to be reputable representatives of the related vendors. Tr. 1769-70.

Some confirmations were signed by senior executives of vendors, for example, Fred Paglia, VP of Field Sales of Nabisco, Mike Rogers, Regional VP of Tyson Foods, Inc., (Tyson's), and Steve LeBarron (LeBarron), Sales Manager of Gwaltney. Tr. 2103; Div. Ex. 116 (Resp. Ex. 746) at KPMG01900-03, KPMG01910-11. Respondents observed that confirmations were being directed to third party brokers, as in 1998, and believed them knowledgeable. Tr. 1763-71, 2092, 2094, 2101-02, 2105. During the 1998 audit Hall and Meyer had noticed that confirmations were sent to third-party brokers and discussed the role of brokers with senior management outside the purchasing group. Tr. 1763, 1768-71, 1782, 2023-25, 2105; Div. Ex. 175 (Resp. Ex. 764).

By 1999 Respondents had acquired knowledge regarding brokers and the USF purchasing process and were familiar with USF's major brokers. Tr. 2100-02; Resp. Ex. 45 at KPMG00054. Specifically, they understood that USF purchased merchandise from approximately 7,000 vendors, and no vendor accounted for more than 10% of its purchases, that USF used a number of brokers, the three primary brokers being CMS, Private Brands, and Frozen Farms, that brokers represented multiple vendors and vendors used multiple brokers, and that brokers directly invoiced USF for purchases. Tr. 1767-68, 2101-02; Resp. Ex. 45 at KPMG00054. Thus, Respondents expected to see brokers paying rebates as a result of product purchases. Tr. 1767-68; Resp. Ex. 45 at KPMG00054. Their understanding of USF's relationship with its brokers was also informed by audit work conducted on other accounts, including inventory (price testing the value that an item is carried on the company's books and records with an invoice from the vendor) and accounts payable (payments for product that had been purchased). Tr. 1763-64, 1771. Other memos in the 1998 and 1999 work papers also recorded the auditors' understanding of the procurement, invoicing, and PA processes at USF. Div. Exs. 8, 9. For example, 1998 work paper D-14 showed that USF had received more than \$7 million from Private Brands and CMS on behalf of more than three dozen suppliers and that KPMG had reviewed USF's accounts payable records and verified that the \$7 million was proportional with cash payments made to those two brokers for food purchases. Resp. Ex. 155.

After USF prepared the letters, KPMG sent them to the recipients by FedEx and received signed confirmations back directly, to assure that KPMG was communicating directly with third parties who were being asked to sign. Tr. 1752-54, 2095-96; Div. Ex. 11 (Resp. Ex. 646) at KPMG01979, Div. Ex. 116 (Resp. Ex. 746). Both Respondents read each response. Tr. 1754, 2096-97. In Hall's experience, often a recipient will differ with the amount to be confirmed. Tr. 1758.

Meyer did not compare the addresses on the confirmations with addresses on invoices because GAAS requires that the confirmation request be sent to a party that the auditor believes is knowledgeable of the information for which confirmation is solicited, not that it be sent to the person to whom invoices are sent. Tr. 2102-03. With reference to the suggestion that Respondents should have investigated the recipients, such as by calling them or performing an internet search, Respondents had no reason to believe that this step, unusual at the time, would provide any additional evidence to confirm their knowledge and it is not required. Tr. 1780-81, 2105-09. Respondents did not attach invoices to the confirmation letters because they were confirming balances, not invoices, and auditors do not typically review or attach invoices to confirmation letters. Tr. 1902-03, 2100, 2102.

Respondents note that Deloitte also used third-party confirmations in auditing the PA account. Resp. Exs. 1101A, 1101C. In its four audits of USF Deloitte sent confirmation letters to some of the same brokers that KPMG had: Larry Stone (Stone), Redgate, Dale Schulz (Schulz), Ritchie Langfield (Langfield), and LeBarron.²⁰ Tr. 736-37; Resp. Ex. 1101D. One of them, Redgate, observed that he continued to sign false confirmations as the fraud became even bigger and more out of control. Tr. 836.

In all, more than thirty individuals signed confirmations in 1998 and 1999 and not one reported that he lacked knowledge about the balances or that the amounts had not been earned by the cutoff date. Tr. 1754-55.

2. Cash Receipts Testing

The audit team began performing cash receipts testing on USF's PA account on a limited basis during the 1998 audit. Tr. 1772, 2134. Cash receipts testing is a single, substantive audit procedure. Tr. 2067. The testing is not required by GAAS. Tr. 1492, 1772-73. In the course of planning the 1999 audit of the PA account, Respondents decided to expand the coverage of the cash receipts testing. Tr. 1772. The expanded cash receipts testing served two audit purposes: one, the test would provide the auditors with a sense of the cash collections trends to ensure USF received actual cash,²¹ and two, the test supplemented the auditor's cutoff testing. Tr. 1727, 1773, 2134, 2250-51; Div. Ex. 11 (Resp. Ex. 646) at KPMG1980. Vouching USF's receipt of cash tested whether the company created false journal entries for cash, or whether the company recognized accounts payable offsets as a cash asset. Tr. 1727. As a supplement to other cutoff work, the cash receipts testing sought to test whether cash was applied to the appropriate accounting period. Tr. 1316, 1773, 2251. In addition, by expanding the breadth of the testing, the auditors ensured that USF did not become too comfortable with their audit procedures. Tr. 2135. The test was not designed to test for prepayments from USF's vendors; indeed, USF maintained that it did not enter into prepayment arrangements with its vendors. Tr. 1773. The evidence, contained in annotated Audit Request Lists dated from July 28 to September 21, 1999, supports Respondents' testimony that they viewed documentation from vendors in addition to documentation that is in the work papers to clear the exceptions. Div. Exs. 91-96 (Resp. Exs. 725-30).

The PA accounting system at USF made cash receipts testing exceptionally difficult. First, the vendors paid USF based on their own information, and not information from USF's

²⁰ Thereafter, Stone, Schulz, and Langfield were convicted on charges arising out of their wrongdoing regarding USF. United States v. Stone, 1:05-cr-01153-RPP (S.D.N.Y. Feb. 10, 2006), United States v. Schulz, 1:05-cr-01154-PKC (S.D.N.Y. Mar. 2, 2006), United States v. Langfield, 1:05-cr-01147-SAS (S.D.N.Y. Apr. 27, 2006). As noted above, Redgate awaits sentencing.

²¹ Respondents found that collection trends were consistent through 1997, 1998, and 1999. Tr. 1881-82, 2131-32.

records, so that invoices and remittances did not often match one another. Tr. 1773-74, 1811, 2136-37. If no account receivable or invoice existed at the time a check was received, USF created an invoice. Tr. 263, 996. Second, sampled vendor checks and remittances provided little information, which necessitated intensive review of the PGM's notes and follow-up with management at USF. Tr. 2136-37. For example, the date on the face of the remittance is not necessarily indicative of the date the PA was earned. Tr. 992. If the remittance lacked sufficient information, the PGM responsible for that vendor directed accounting personnel in how to apply the payment. Tr. 218, 227; Div. Ex. 11 (Resp. Ex. 646) at KPMG1980. Third, checks from brokers paid off multiple vendor PAs. Tr. 1810. Finally, the company's practice of applying cash receipts to the oldest open PAs further complicated matters. Tr. 225-27, 996. The cash receipts testing project proved to be so difficult that Hall tasked Meyer to assist Jason Antonakas with it. Tr. 1773-74, 2005, 2133.

For testing, the auditors requested checks and check remittances with amounts greater than \$100,000 from USF. Tr. 914, 930, 935, 2133. The sample set was summarized in audit work paper D-31. Tr. 2136. Meyer placed a bold asterisk by six items from the sample set that, after consulting with the purchasing group at USF, the auditors thought required further inspection, explanation, and documentation. Tr. 1775, 1787, 2142-43, 2247; work paper D-31. In some cases, the remittance information for the six items differed from the PGM's notes on allocation of the items. Tr. 2247; Div. Ex. 16 (Resp. Ex. 651). Hall was involved in determining which sample items required more attention and concurred with Meyer's judgment on those items. Tr. 1775, 2143, 2148. Respondents then went to Megas and Kaiser for assistance in resolving the discrepancies. Tr. 1775-76, 2148-49; Div. Ex. 11 (Resp. Ex. 646) at KPMG1980. Kaiser, as a company executive and head of the PA program, was a logical source for information as the auditors sought to clear the discrepancies. Tr. 2150-51. The six discrepancies (also referred to as exceptions) were described in a memo presented to Megas. Tr. 1776-80, 1786; Div. Ex. 94 (Resp. Ex. 728).

The auditors' conclusions about the sample set are documented in work paper D-25a. Tr. 2150; Div. Ex. 11 (Resp. Ex. 646) at KPMG1980. In discussing the exceptions, the work paper mistakenly states: "Mr. Kaiser obtained confirmation from the vendors that such cash receipts were in fact for fiscal 1998 and were not prepayment on fiscal 1999 programs or other advances." Tr. 2151; Div. Ex. 11 [Resp. Ex. 646] at KPMG1980. Actually, the cash tested in the sample set was applied to both fiscal 1998 and fiscal 1999. Tr. 1959-62, 2353-59. Respondents noted the mistake in discussions with the Division in 2005. Tr. 2354-56; Div. Ex. 220 at 25-26.

Of the six discrepancies noted by a bold asterisk on D-31, two were flagged because the remittance mentioned "prepay" or "advance." Tr. 1778-79. A remittance from a Nabisco wire transfer for \$1.8 million dated January 8, 1999, said "advance on Baked Goods Agreement" for \$1.2 million of the total funds. Tr. 1777, 2156; Div. Ex. 48 [Resp. Ex. 682]. The remittance noted that the remaining \$600,000 was for a "conversion allowance." Div. Ex. 48 [Resp. Ex. 682]. A remittance from a \$2.2 million Tyson's check dated December 14, 1998, said "99 M/A prepay." Tr. 1778; Div. Ex. 51 [Resp. Ex. 685]. A handwritten note on the Tyson's remittance noted "only \$100K is prepay." Div. Ex. 51 [Resp. Ex. 685]. In response to Respondents' query about these items, Megas represented that USF did not enter into prepayment agreements with its

vendors. Tr. 1779, 2149. Nevertheless, Respondents requested that Megas secure documentation from the vendors stating that the items were not prepayments. Tr. 1779, 1784. Megas agreed to secure the documentation from the vendors. Tr. 1781. Additionally, Hall discussed the discrepancies, particularly the Tyson's discrepancy, with Miller. Tr. 1782. Miller assured Hall that the Tyson's agreement had no prepayment provisions. Tr. 1782.

In response to Respondents' request for additional information about the Nabisco item, USF provided a letter from Nabisco to USF, dated December 28, 1998, that congratulated USF for "max[ing] out your 1998 Earned Income Program with Nabisco" and telling USF that a wire transfer of \$1.2 million would follow. Tr. 2156-57; Div. Ex. 80 (Resp. Ex. 714). Respondents understood this letter to mean that the \$1.2 million was earned, and not a prepayment or advance. Tr. 2157. The remaining \$600,000 mentioned in the Nabisco wire remittance was reviewed as part of the unbilled PA work by Respondents. Tr. 2157; Div. Ex. 48 (Resp. Ex. 682). The \$600,000 payment resulted from converting Rykoff purchases from other vendors to Nabisco after the merger. Tr. 2156. Based on this letter from Nabisco, along with the confirmations and the contract review work performed in 1998 and 1999, Respondents concluded that the \$1.8 million wired by Nabisco had been earned by USF, and did not represent a prepayment. Tr. 2157.

In response to Respondents' request for additional information about the Tyson's item, USF provided a letter from Tyson's to USF, dated July 21, 1999, that thanked USF for "continued commitment and growth pertaining to our program agreements. As a result of this growth, a payout of \$2,266,881 was submitted." Div. Ex. 84 (Resp. Ex. 718). Based on this letter, the Tyson's contract review work from 1998 and 1999, and the confirmations, Respondents concluded that USF's treatment of the payment was appropriate. Tr. 2163.

As found above, letters drafted by Kaiser were obtained from Nabisco, Tyson's, and others that appeared to state that payments had been earned and that could be shown to the auditors without alerting them to the fact that the payments were prepayments.²² Tr. 529, 539, 590-603, 694-96; Div. Exs. 80, 83, 84; Resp. Exs. 714, 717, 718, 399 at AH0529576, 669. Reference to additional documentation that is not in the work papers or elsewhere in the record of evidence that Respondents claim to have sought and obtained is found in notes to agendas for meetings with USF management and supports their claim that they sought such evidential matter. Div. Ex. 94 (Resp. 728).

A third discrepancy, a \$240,000 check from Dakota Growers, was flagged because the auditors did not understand the remittance. Tr. 2160-61. A concern existed that the remittance may indicate a prepayment. Tr. 2237-38; Div. Ex. 94 (Resp. Ex. 728). The remittance for the discrepancy stated that a check was for "FINAL 5YR CNTRT PYMT." Tr. 2236-37; Div. Ex. 68 (Resp. Ex. 702); Div. Ex. 94 (Resp. Ex. 728). Respondents discussed the item with management, asking for additional documentation from the vendor. Tr. 2160-61; Div. Ex. 94 (Resp. Ex. 728). USF provided an email from the vendor supporting this transaction, as well as a second exception related to Dakota Growers. Tr. 2161, 2240. The email was purportedly from a

²² As of September 21, 1999, however, Respondents were still seeking further documentation as to Tyson's. Div. Ex. 97 (Resp. Ex. 731).

vendor who had signed the Dakota Growers' confirmation. Tr. 2161, 2240. The auditors reviewed 1998 and 1999 confirmations returned by Dakota Growers. Tr. 2162. Meyer had previously reviewed the Dakota Growers contract. Tr. 2162; Resp. Ex. 160. Based on this evidence, Respondents concluded USF's treatment of the item was not inappropriate. Tr. 2162.

The other discrepancies were flagged because the auditors did not understand how the payments were applied by USF. Tr. 1784. Of these, a second discrepancy related to Dakota Growers. Tr. 1786, 2160. The item was flagged for follow-up because the auditors wanted more information about USF's treatment of the transaction. Tr. 2160-61. The remittance for the second Dakota Growers' discrepancy stated "SEMO Rebate July & Aug." Tr. 2239; Div. Ex. 70 (Resp. Ex. 704); Div. Ex. 94 (Resp. Ex. 728). The check was dated October 13, 1998, for a total of \$123,868. Div. Ex. 70 (Resp. Ex. 704). USF had applied the check to a June 1998 receivable, and the auditors flagged the item for follow-up. Tr. 2239; Div. Ex. 94 (Resp. Ex. 728). Respondents discussed the discrepancy with management and asked for more documentation from the vendor. Tr. 2161; Div. Ex. 94 (Resp. Ex. 728). As noted above, USF provided an email to Respondents that purported to be from Dakota Growers' vendor. Tr. 2161, 2240. The email noted that the amount was earned and that Dakota Growers' references did not correspond to USF's. Tr. 2240-41. The vendor communication, along with the other audit work from the 1998 and 1999 audit, led Respondents to determine USF had not accounted for the Dakota Growers' payments in an inappropriate manner. Tr. 1798, 2161.

The next discrepancy related to an item applied to Commodities Specialty Companies (CSC), a frozen seafood vendor that sold to wholesalers. Tr. 742-43, 2163-64. The check was from Seafood Marketing Specialists dated December 28, 1998, for \$450,000. Div. Ex. 73 (Resp. Ex. 707). Seafood Marketing Specialists was a VASP that dealt in commodity seafood. Tr. 548. The item was flagged by the auditors because the remittance on the check noted "Corp. 1 payment" and the auditors did not understand what that meant. Tr. 2164, 2243-44; Div. Ex. 73 (Resp. Ex. 707). The auditors obtained additional documentation from the vendor. Tr. 2164-65. Based on the new documentation and the other work done on the account, Respondents concluded that the item was no longer a discrepancy. Tr. 2164-65.

The final discrepancy slated for follow-up by the auditors related to a \$4 million check from Superior Coffee to USF dated June 29, 1999. Tr. 1798, 2154; Div. Ex. 35 (Resp. Ex. 669). The handwritten note indicated the item was a "joint promo between Kitchens of Sara Lee and Sup. Coffee." Tr. 1798-99, 2153-54; Div. Ex. 35 (Resp. Ex. 669). The auditors needed more information to understand the nature of the item. Tr. 2154, 2219. The item was not flagged for review because of a prepayment issue. Tr. 2154. Sara Lee was the parent company of Superior Coffee, so it was not unusual for a payment from Superior Coffee to be associated with Sara Lee. Tr. 2155. Respondents spoke to Kaiser and Megas about the item, and requested they procure additional documentation from the vendor to support the accounting treatment of the item. Tr. 2155. The auditors received additional documentation from the vendor via USF. Tr. 2155-56. The documentation was consistent with names from the confirmations. Tr. 2233-34. Based on the additional information, and the other work done in the PA account area, Respondents concluded that USF's treatment of the item was not inappropriate. Tr. 2156.

3. White-Out and Work Paper D-32

Asterisks and notes concerning the six discrepancies were covered with white-out on work paper D-31. The underlying material can easily be read through the white-out on the original of D-31, but cannot be read on photocopies. However, even on photocopies, the white-out is ineffective in covering up the existence of the discrepancies as other language on the same page and elsewhere in the work papers referred to the whited-out material. Additionally, work paper D-25a refers to D-32, which either never existed, was deliberately destroyed, or simply cannot be found.

Hall and Meyer deny applying the white-out or knowing who did. Tr. 1805, 1932, 2145. Similarly, each denies any knowledge concerning the existence or non-existence of D-32. Tr. 1804, 2151, 2266-72, 2352. There is no evidence in the record to support a finding that either Respondent was involved in the white-out. Likewise there is no evidence to support a finding as to what happened to D-32 or whether it ever existed, much less a finding that either Respondent engaged in any sort of wrongdoing concerning D-32.

D. Respondents' Review of USF's Second Quarter 2000 Financial Statements

Respondents performed a review of USF's second quarter 2000 financial statements. Tr. 1826. A review differs in objective and method from an audit conducted in accordance with GAAS. See AU § 722.09, in evidence as Div. Ex. 199 (Resp. Ex. 784).

The objective of a review of interim financial information is to provide the accountant, based on applying his or her knowledge of financial reporting practices to significant accounting matters of which he or she becomes aware through inquiries and analytical procedures, with a basis for reporting whether material modifications should be made for such information to conform with generally accepted accounting principles.

Id. Generally during a review, accountants perform analytic procedures on the quarterly statements and question management. Tr. 2177. Respondents undertook both during the second quarter 2000 review. Tr. 2177-78. As part of their review, Respondents determined that cash payments of approximately \$15 million had been made to USF vendor United Signature Foods (Signature). Tr. 1826-27, 2180.

USF entered into a supply agreement with Signature in August 1998, as part of a sale of assets by USF to Signature. Tr. 1822-23. For the assets, USF received cash and a promissory note. Tr. 1823. In conjunction with the sale of assets to Signature, USF entered into a six year, \$750,000 minimum purchase supply agreement with Signature. Tr. 1823. USF requested that Hall advise it on the proper accounting treatment of the transaction. Tr. 1823. Hall reviewed the sales and purchase agreements, and recommended that the gain on the equipment be deferred. Tr. 1823-24. The transactions resulted in USF accruing a deferred gain. Tr. 1825. Meyer reviewed the sales contract as part of her audit duties during the fiscal year end 1999 audit. Tr. 2174, 2324. Respondents knew the contract had penalty provisions for failing to meet purchasing obligations. Tr. 1870, 2184, 2325-26. Under the terms of the contract, the penalties were assessed on an annual basis or on a rolling thirteen week basis, depending on how far below target USF's purchasing had fallen. Tr. 1870-71, 2325. If the purchasing amounts fell below

95% of the target, the penalty was payable on an annual basis, but if the purchasing amount fell below 85% of the target, the penalty amount was payable on a rolling thirteen week basis. Tr. 1870-71, 2325. At the time of the 1999 audit, USF was in compliance with the terms of the agreement. Tr. 2175.

During the second quarter 2000 review, Meyer noticed that USF had decreased the amount of the deferred gain it booked from the Signature transaction. Tr. 1827, 2180. In the course of performing analytic procedures, Meyer discovered approximately \$15 million in cash payments from USF to Signature. Tr. 2183. The account reconciliation identified those payments as cash deposits. Tr. 2182-83. The payments entailed more than a single check. Tr. 2326-27. USF led Meyer to believe that the payments were being made to assist Signature. Tr. 2183. USF represented it was Signature's primary customer, and the payments were meant to ensure that Signature could continue operations. Tr. 1872, 2183, 2333. Respondents also understood that USF was behind on its purchases from Signature. Tr. 1872, 2327. Meyer brought the cash payments to Hall's attention. Tr. 1827. Hall knew that the agreement called for penalty payments if USF was not meeting its purchasing targets. Tr. 1827.

During the course of her review, Meyer asked USF management whether the sales contract had been amended, and management represented to her that it had not. Tr. 2180-81. USF, during a meeting with Hall, also failed to mention amendments to the contract. Tr. 1829. Those amendments were important in understanding the nature of the cash payments to Signature. Tr. 2181.

USF never disclosed that it was paying penalty payments to Signature for not meeting its purchasing requirements. Tr. 1871, 2182. During follow-up discussions with USF's management about the payments, the company never represented to Meyer that the payments were penalty payments for failing to meet purchasing requirements. Tr. 2184. USF maintained that it was behind on its own internal purchasing targets with regards to Signature. Tr. 2327. However, USF never disclosed that it was below the 85% minimum purchasing threshold. Tr. 2327-28.

E. Expert Testimony²³

Douglas R. Carmichael, CPA, Ph.D. (Carmichael), testified for the Division. Tr. 1097-1301, 1311-1579, 1599-1641; Div. Ex. 228. He was accepted as an expert in the applicable professional standards for accountants, specifically GAAS. Tr. 1117-18. His career included employment at the AICPA, where he was vice-president of auditing when he left in 1983, and at Baruch College of the City University of New York, where he taught auditing for the next twenty years. Tr. 1100-04, 1106. From 2003 to 2006 he was the first chief auditor of the Public Company Accounting Oversight Board (PCAOB), which was established to regulate independent auditing of public companies by the Sarbanes-Oxley Act in 2002. Tr. 1106-07. He has been a tireless advocate of increasing auditors' responsibility to detect fraud: he had a role in

²³ To the extent that the experts' evidence does not lead to findings of fact, it will be summarized here and referred to as appropriate in the Conclusions of Law section of this Initial Decision.

drafting SAS No. 82, which was in effect for the 1999 audit. Tr. 1110, 1402-03. While conceding that SAS No. 99, which replaced SAS No. 82, increased auditors' responsibility to detect fraud by, *inter alia*, requiring that auditors assume that management is inclined to commit fraud when planning the audit, he believes that the present requirements do not go far enough. Tr. 1422-30. He has stated that "collusion" may be a weasel word for auditors attempting to evade responsibility for detecting collusive fraud. Tr. 1431-33. Likewise, in his efforts to increase the quality of auditing, Carmichael participated in efforts to increase the documentation required in work papers. Tr. 1447-84. While SAS No. 41 (in evidence as Resp. Ex. 812), in effect during the 1999 audit, permitted an auditor to support his report by means other than documents, such as oral explanations in some circumstances, and the post-Enron successor standard SAS No. 96 (in evidence as Resp. Ex. 813) increased required documentation to be sufficient to enable members of the engagement team with supervision and review responsibilities to understand the report, when Carmichael became chief auditor of the PCAOB, he issued a new, higher, standard – Auditing Standard (AS) No. 3 (in evidence as Resp. Ex. 1088), which requires documentation sufficiently detailed to allow an external reviewer such as the PCAOB to review the work.

Generally, Carmichael opined that Respondents detected evidence of prepayments; because management had represented that there were no prepayments, Respondents should have had heightened professional skepticism and, accordingly, should have investigated the recipients of confirmations more thoroughly. Likewise, under the circumstances, he opined that in their cash receipts testing they cleared instances of possible prepayments and payments applied to incorrect periods based on insufficient evidential matter or matter that was insufficiently documented in their work papers. Additionally, he opined that Respondents fell short in their second quarter review.

While Respondents considered the PA account to be at high risk of material misstatement, this was because of a lack of internal controls. Carmichael's opinions concerning shortfalls in the confirmation and cash receipts testing are based on their assumed discovery of prepayments in the face of management denials that USF engaged in accepting prepayments. However, Respondents did not in fact have knowledge or imputed knowledge of prepayments. The fact that "prepay" appeared on the Nabisco remittance advice is not dispositive in raising such a management integrity issue. For example, "prepay" can have more than one meaning, for example, an estimated payment on amounts that had been earned. Tr. 2031-34. Respondents did not immediately question management integrity on seeing the word "prepay"; in the exercise of judgment, they gathered additional information that convinced them of an innocent explanation at the time in question. Tr. 2034-36. Likewise, this led them to overlook the significance of USF's policy of applying cash to the oldest receivables in their cash receipts testing, and to more readily accept explanations for what in hindsight was application of cash to the wrong period, such as to accept explanations that "1999" referred to the payment period, not the earned period. Div. Ex. 94 (Resp. Ex. 728). (Although it now appears that cash that should have been applied to 1999 receivables was applied to 1998 receivables, the 1998 audit is not at issue in this proceeding.) Additionally, part of the reason for the cash receipts testing was to test if actual cash was coming in, as contrasted with an adjustment to accounts payable. Tr. 2250-53. Also, Respondents' judgment was that collectibility was not an issue since USF's payables were much greater than its receivables in reference to each vendor. Tr. 1742-43.

J. Duross O'Bryan, CPA (O'Bryan), testified for Respondents. Tr. 2361-66, 2373-78; Resp. Ex. 1100.²⁴ He was accepted as an expert in auditing companies' financial statements and in conducting quarterly interim reviews of companies' interim financial statements. Tr. 2370. During his career he has been an auditor; he started at a "Big 8" firm in 1978 and became a partner in what is now PricewaterhouseCoopers, which he left in 2003 to join Alix Partners, LLP, a financial consulting firm. Tr. 2362-65; Resp. Ex. 1100 at 3. During his years as an auditor, he participated in over 200 audit engagements and many more quarterly reviews, and has audited promotional allowances on several engagements and performed confirmation and cash receipts testing on dozens of engagements. Tr. 2362, 2364; Resp. Ex. 1100 at 2.

Noting that GAAS states that even a properly planned and executed audit may fail to detect fraud, especially collusive fraud, O'Bryan opined that the auditors planned and performed the 1999 audit and the second quarter review in accordance with GAAS. Resp. Ex. 1100 at 2.

III. CONCLUSIONS OF LAW

Respondents were charged, pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(ii), with improper professional conduct. The charges were based on their alleged improper practices in the fiscal year 1999 audit related to the PA account and in their second quarter fiscal year 2000 review related to the characterization of payments made under a supply contract. The Division argues that their conduct violated GAAS and was reckless, or, in the alternative, highly unreasonable, or, in the alternative, constituted repeated instances of negligent conduct. Respondents contend that their audit of the PA account and second-quarter review were within professional standards. In this section it is concluded that their conduct was within professional standards and was neither reckless, nor highly unreasonable, nor negligent.

A. Rule 102(e)(1)(ii)

Rule 102(e)(1)(ii) provides for sanctions against accountants who "have engaged in . . . improper professional conduct."

[W]ith respect to persons licensed to practice as accountants, "improper professional conduct" under Rule 102(e)(1)(ii) means:

- (A) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
- (B) either of the following two types of negligent conduct:
 - (1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in

²⁴ At the hearing, the Division moved to strike portions of Resp. Ex. 1100, O'Bryan's expert report. Tr. 2366-69. It later reduced its motion to writing and filed the written motion on September 14, 2007. The motion was denied at Tr. 2372.

circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

(2) repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

17 C.F.R. § 201.102(e)(1)(iv).

1. Reckless Conduct

The Commission defines recklessness under Rule 102(e) to be the same as recklessness under the antifraud provisions (for the purpose of consistency in the federal securities laws; “professional standards” are not fraud-based). Thus, recklessness is “an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it.” Amendment to Rule 102(e) of the Commission’s Rules of Practice, 68 SEC Docket 707, 710; 63 Fed. Reg. 57164, 57167 (Oct. 26, 1998) (Rule 102(e) Amendment). It is “a lesser form of intent,” “not merely a heightened form of ordinary negligence.” Id. (internal citations and quotations omitted).

Rule 102(e)(1)(iv)(A) codified the Commission’s longstanding recklessness standard in 1998. See Russell Ponce, 54 S.E.C. 804, 823 n.52 (2000) (holding that the 1998 amendment adding new subsection (iv)(A) to Rule 102(e)(1) merely codified the Commission’s longstanding recklessness standard), aff’d, 345 F.3d 722 (9th Cir. 2003); accord Albert Glenn Yesner, CPA, 54 S.E.C. 414, 417 (1999).

Recklessness is more than a misapplication of accounting principles; the Division must prove that Respondents’ “accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments . . . were such that no reasonable accountant would have made the same decision if confronted with the same facts”; reasonable accountants can differ, and evidence indicating that questioned accounting decisions were reasonable negates an attempt to establish scienter. See Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994), quoting SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992) (internal quotations omitted); accord Software Toolworks Inc., 50 F.3d 615, 627 (9th Cir. 1994) (“The mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter.”) (citations and internal quotation marks omitted). Violations of GAAP or GAAS in themselves do not constitute recklessness. See Chill v. General Elec. Co., 101 F.3d 263, 270 (2d Cir. 1996) (“Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient.”). “Subjective good faith is inconsistent with knowing, intentional, or reckless conduct.” Rule 102(e) Amendment, 68 SEC Docket at 713, 63 Fed. Reg. at 57170.

2. Highly Unreasonable Conduct

“Highly unreasonable” was first defined in Rule 102(e) Amendment as a new concept. It is higher than ordinary negligence but lower than recklessness. It is measured by the degree of

departure from professional standards and not the intent of the accountant. It is not judged by hindsight, but compares actions taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken. Rule 102(e) Amendment, 68 SEC Docket at 710-11, 63 Fed. Reg. at 57167-68. A single instance of highly unreasonable conduct when an accountant knows, or should know, that heightened scrutiny is warranted conclusively demonstrates a lack of competence to practice before the Commission. Rule 102(e) Amendment, 68 SEC Docket at 707, 63 Fed. Reg. at 57164. A single judgment error, even if unreasonable when made, may not indicate a lack of competence to practice before the Commission and not pose a future threat to the Commission's processes requiring Commission action. Rule 102(e) Amendment, 68 SEC Docket at 709 & n.28, 710, 63 Fed. Reg. at 57166 & n.28, 57167.

3. Repeated Instances of Unreasonable Conduct

“Unreasonable” connotes an ordinary negligence standard. Rule 102(e) Amendment, 68 SEC Docket at 712, 63 Fed. Reg. at 57169. “[R]epeated’ may encompass as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits [such as] fail[ure] to gather evidential matter for more than two accounts, or certific[ation of] accounting inconsistent with GAAP in more than two accounts.” Id. “[Since] ‘repeated instances’ may not always demonstrate a lack of competence to practice before the Commission . . . this subparagraph requires . . . a specific finding that the conduct indicates a lack of competence.” Id.

Respondents urge that their conduct during the 1999 audit concerns one account, the PA account, and is, therefore, one instance of conduct occurring within that audit.²⁵ The Division argues that their conduct in regard to each vendor and each item of testwork constitutes one instance of conduct such that there were multiple instances of conduct during the audit. A fair reading of Rule 102(e) Amendment favors Respondents’ view. Id.

4. Applicable Professional Standards

²⁵ “Improper professional conduct” within the meaning of Rule 102(e)(1)(ii) is defined in terms of audits; interim review of unaudited financial statements is not mentioned. Rule 102(e) Amendment, passim. Thus, it could be questioned whether any shortfall in Respondents’ conduct in the second quarter review could serve as a “repeated instance of unreasonable conduct” or as “reckless” or “highly unreasonable conduct.” At any rate it would pose less of a threat to the Commission’s processes than deficient auditing.

The undersigned is mindful that the Commission’s amendment of Rule 102(e) was prompted by a judicial decision, Checkosky v. SEC, 139 F.3d 221 (D.C. Cir. 1998), in which the court remanded that case to the Commission with instructions to dismiss the proceedings on the ground that Commission opinions in the case had not articulated clearly the “improper professional conduct” element of the rule. For that reason, the undersigned would be reluctant to extend “improper professional conduct” to conduct outside of that addressed in Rule 102(e) Amendment.

An auditor does not guarantee that financial statements are free of material misstatement. His or her “responsibility [is] to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” AU § 110.02. During the time at issue, applicable professional standards included GAAP, GAAS, the AICPA Code of Professional Conduct and Commission regulations.²⁶ Rule 102(e) Amendment, 68 SEC Docket at 709; 63 Fed. Reg. at 57166.

Respondents’ conduct must be compared with actions a reasonable accountant would have taken at the time of the audit and review, without the benefit of hindsight, and evaluated in light of standards in effect in 1999. The conduct at issue predated the effective date of the Public Company Accounting Reform and Investor Protection Act of 2002, known as the Sarbanes-Oxley law, which mandated procedures to reduce accounting fraud in the wake of Enron and other accounting fraud scandals; thus the new procedures and policies that increased auditors’ responsibilities to detect fraud instituted pursuant to that law are inapplicable in evaluating Respondents’ conduct of the 1999 audit and the fiscal year 2000 second-quarter review. Of particular relevance in this proceeding are changes with reference to AU § 316 (Consideration of Fraud in a Financial Statement Audit) and AU § 339 (Working Papers).

During the relevant period AU § 316 was based on SAS No. 82, issued in 1997, while SAS No. 99, issued in 2002 and effective for calendar year 2003 audits, increased the requirement for professional skepticism and required substantial additional procedures to make it more likely that material fraud will be detected. In particular, SAS No. 99 requires a brainstorming session by the audit team during initial audit planning to determine the different ways the client might perpetrate fraud, with an emphasis on the possibility of improper revenue recognition, which is presumed to be a fraud risk. By contrast, SAS No. 82 merely required the auditor to assess the risk of material misstatement due to fraud and consider that assessment in designing the audit. In essence, SAS No. 99 now requires the auditor to assume that the client is engaged in fraud, particularly with regard to revenue recognition, while SAS No. 82 merely required the auditor to assess the risk of fraud without assuming either the existence or non-existence of fraud. Thus, a 1999 audit that would not have complied with the professional standards set forth in SAS No. 99 could have been compliant with SAS No. 82.

During the relevant period AU § 339 was based on SAS No. 41, which permitted an auditor to support his report by means other than documents, such as oral explanations. Subsequently, the post-Enron successor standard SAS No. 96 increased required documentation, mandating that evidential matter be sufficient to enable members of the engagement team with supervision and review responsibilities to understand the report. Still later, the PCAOB issued

²⁶ The ten basic GAAS standards are listed in AU § 150.02, and detailed interpretations follow. Those at issue in this proceeding are the third general standard (Due Professional Care) and AU § 230 (Due Professional Care); the third standard of field work (Sufficient Competent Evidential Matter) and AU §§ 316 (Consideration of Fraud in a Financial Statement Audit), 326 (Evidential Matter), 330 (The Confirmation Process), 333 (Management Representations), and 339 (Working Papers). Concerning the second quarter interim review, AU § 722 (Interim Financial Information) applies.

an even higher standard, AS No. 3, which requires documentation sufficiently detailed to allow an external reviewer such as the PCAOB to review the work that led to the auditors' conclusions.

Thus, to conclude that Respondents engaged in improper professional conduct within the meaning of Rule 102(e), it is necessary to conclude, first, that they violated GAAS and, second, that the GAAS violation[s] resulted from reckless or highly unreasonable conduct, or repeated instances of unreasonable conduct by them. A GAAS violation in itself is not improper professional conduct within the meaning of Rule 102(e).

B. Respondents Did Not Violate GAAS

1. The 1999 Audit

The size of the fraud during the 1999 fiscal year cannot be determined from the evidence in the record. USF never restated its 1999 financial statements, however, and the record suggests that the fraud was not material to USF's financial statements in a quantitative sense. Nonetheless, a fraud involving fraudulent revenue recognition directed by a member of management is material without regard to any quantitative measure of materiality. Respondents' audit did not bring the fraud to light, and the issue for decision is whether they complied with GAAS as to the procedures that they planned and executed concerning the PA account. As AU § 316.10 warns, "Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud." It is concluded that this was such an audit, and that Respondents did not violate GAAS.

Respondents did not know there was a fraud and that prepayments were being accounted for improperly. The record is clear that Kaiser had kept the fraud on a need-to-know basis and most certainly concealed it from Respondents. However, they addressed the possibility of fraud as well as the risk of material misstatement due to error in planning their audit of the PA account and undertook various procedures. As required by AU § 316, Respondents identified the PA account in the context of a lack of integrated information systems as a risk factor for fraud and identified PA income and receivables as a critical audit objective. Their response to the fraud risk factor at the corporate level was to review PA income, receivables, and selected confirmations. Additionally, most of the work on the PA account was done by Meyer, the senior manager, rather than less experienced personnel. In the execution of the audit plan, had Respondents detected fraud, they would have been required to consider the implications for the integrity of management and the possible effects on other aspects of the fraud by AU §§ 312.07, 316.34-.36. However, the evidence shows that they did not detect fraud.

In arguing that Respondents engaged in improper professional conduct in their audit of the PA account, the Division focuses on their planning and execution of two procedures: cash receipts testing and confirmations. The confirmations were intended to test the existence of balances earned and the cash receipts testing was intended, in part, to test whether vendors actually made cash payments on the balances. The Division focuses on the period to which the

cash payments were applied, especially pointing to Respondents' failure to detect prepayments recorded as current earnings.

a. Cash Receipts Testing

From the cash receipts test sample set Respondents questioned several payments and eventually flagged six audit exceptions as possible prepayments or payment misapplications. As found in the Findings of Fact, their claim that they cleared the six exceptions is supported by the evidence of record. Of particular concern are two payments that may, in fact, have been prepayments. The wire transfer for the January 8, 1999, Nabisco payment stated "Advance," and the remittance for the December 14, 1998, Tyson's payment stated "99 m/a prepay." Kaiser caused these vendors to send letters that had been carefully crafted to deceive the auditors into believing that there were no prepayments as to the sums mentioned and that the payments had been earned. Carmichael concedes that the letters could reasonably be interpreted to provide assurance that USF had earned the amounts paid although arguing that they are ambiguous. Since Respondents were required to have professional skepticism, not to assume that the client was engaged in fraud, their understanding that the letters represented that the amounts paid had been earned cannot be faulted. While Carmichael pointed to round number payments, partial payments, and late payments²⁷ as red flags requiring further investigation into the PA account, these were consistent with the known PA arrangements that USF had with its vendors. Vendors made PA payments based on their own records, USF pressured vendors at year-end and at mid-year to make payments, and extracted additional payments at those times. While a different approach could have been taken, it cannot be said that a reasonable auditor would not have adjudged these practices as red flags necessitating an inquiry into the possibility of improper revenue recognition of prepayments. Nor can it be said, as argued by the Division, that Respondents cleared the exceptions solely based on the representations of management, Kaiser in particular. They queried management other than Kaiser, including personnel who were not part of the fraud and the CFO, and viewed documentation from vendors and contracts that did not contain prepayment terms.

Assuming, arguendo, that Respondents did violate GAAS, their conduct was not reckless. Even if it is assumed that they did not go far enough in obtaining sufficient competent evidential material, they did not disregard contradictory evidence in their possession or engage in "an egregious refusal to see the obvious, or to investigate the doubtful." Potts v. SEC, 151 F.3d 810, 812 (8th Cir. 1998) (quoting Worlds of Wonder, 35 F.3d at 1426) (upholding Commission sanction of a concurring auditor who concurred with backdated accounting treatment by relying on untested representations despite much contradictory evidence). The evidence on which Respondents relied was not "doubtful" and it was not "obvious" that the PA program was riddled with fraud and prepayments accounted for as earnings in the present period.

Nor was it highly unreasonable – or unreasonable – not to have sought further additional evidential material to clear the exceptions. Respondents evaluated the sample set selected for

²⁷ USF's practice of applying all payments to its oldest receivables was not concealed within the company or from the auditors and was not in itself a GAAP violation.

cash receipts testing, flagged certain payments, discussed them with management, and despite management assurances that they were not prepayments, sought and accepted additional evidential material that turned out, in hindsight, to have been insufficient or fraudulent.

b. Confirmations

AU § 330.26 requires the auditor to “direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed.” It is clear that Respondents believed that the recipients of the confirmations, which included high officials of vendors and brokers, were knowledgeable. In fact, these individuals were knowledgeable; they knew that they were confirming false values in collusion with Kaiser and other USF insiders. In planning the confirmation procedures, Respondents were informed by information from prior years’ audits and confirmations, in accordance with AU § 330.23. The Division argues that Respondents should have investigated the recipients of the confirmation letters, whose addresses were provided by Kaiser, and should have considered the fact that a number of them were directed to entities that Respondents knew to be brokers as a red flag calling for further investigation. However, it was reasonable for Respondents to have obtained the addresses to which the letters should be directed from Kaiser because he was most knowledgeable. Indeed, the recipients of the Nabisco and Tyson’s letters were vice presidents of those companies. The fact that all the letters were returned (instead of not being returned or returned with a negative confirmation) reasonably gave Respondents confidence that they had been directed to appropriate persons. Only using hindsight and knowing that Kaiser was perpetrating a fraud, with the aid of these recipients, would it appear appropriate to investigate their good faith.

2. The Second Quarter Interim Review

The Division alleges that USF’s accounting for \$15 million in payments to Signature was not in accordance with GAAP and that Respondents, in their interim review of USF’s second quarter fiscal year 2000 financial information, fell short of professional standards in allowing USF to improperly account for the payments and failing to report this probable GAAP departure to the audit committee.

This charge concerning the second quarter 2000 review is much less serious than the charges concerning the 1999 audit and, even if proven, indicates a much smaller threat of harm to the Commission’s processes, particularly when considered as of the time at issue. At that time – USF’s fiscal year 2000 second quarter, which ended January 1, 2000 – issuers were not required to obtain an interim review by an independent public accountant of the financial information included in their Forms 10-Q.²⁸ USF’s Form 10-Q for that period, containing

²⁸ The Commission amended 17 C.F.R. § 210.10-01(d) to require such interim reviews for fiscal quarters ending on or after March 15, 2000. Audit Committee Disclosure, 71 SEC Docket 925, 64 Fed. Reg. 73389 (Dec. 30, 1999). According to the Commission, however, the then “Big 5” accounting firms already required audit clients to engage them for interim reviews as a condition of audit engagements. Audit Committee Disclosure, 71 SEC Docket at 934, 64 Fed. Reg. at 73398. In the event, of course, KPMG did not audit USF’s 2000 financial statements.

unaudited financial information (labeled as such), did not disclose that an interim review had taken place. Thus, its disclosures could not have led investors to assume that the unaudited financial information had been reviewed by KPMG or any other accountant and were thus more trustworthy than unreviewed financial information.

Second, it must be stressed that interim review is a nonaudit service²⁹ and is more limited in objective and method from an audit conducted in accordance with GAAS. As the parties and their experts agree, AU § 722 prescribes the professional standards applicable to an interim review.³⁰ Pursuant to AU § 722, procedures are normally limited to analytical procedures and inquiries of management. If an “accountant becomes aware of information 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.” AU § 722.18. Assuming, *arguendo*, that USF’s accounting for the payments to Signature was a probable GAAP departure, it cannot be said that Respondents’ interim review was not in accordance with the standards set forth in AU § 722. In performing analytical procedures, Meyer discovered the reduction in deferred gain and the \$15 million in payments. Meyer, and Hall, as well, made inquiries of management and were told that the payments were cash flow payments made by USF, Signature’s primary customer, meant to ensure that Signature could continue operations. This explanation was

²⁹ When providing such nonaudit services, an accountant is not referred to in professional literature by the term “auditor,” which “is reserved for a person who undertakes to perform an audit in accordance with [GAAS] and expresses an opinion based on the results of that audit.” Vincent M. O’Reilly, et al., *Montgomery’s Auditing* 30-3 (12th ed. 1998). See also AU § 722 *passim*.

³⁰ AU § 722.09 summarizes the objective and procedures of an interim review:

The objective of a review of interim financial information is to provide the accountant, based on applying his or her knowledge of financial reporting practices to significant accounting matters of which he or she becomes aware through inquiries and analytical procedures, with a basis for reporting whether material modifications should be made for such information to conform with [GAAP]. The objective of a review of interim financial information differs significantly from the objective of an audit of financial statements in accordance with [GAAS]. The objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements taken as a whole. A review of interim financial information does not provide a basis of the expression of such an opinion, because the review does not contemplate (a) tests of accounting records through inspection, observation, or confirmation, (b) obtaining corroborating evidential matter in response to inquiries, or (c) the application of certain other procedures ordinarily performed during an audit. A review may bring to the accountant’s attention 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.

consistent with their understanding of USF's business and its relationship with Signature and the documents they reviewed. The Division urges that Respondents should have been wary of management's explanation because of the management integrity issues that they encountered during the 1999 audit. However, as found above, Respondents did not, in fact, become aware of management integrity issues during the 1999 audit. In sum, given the limited nature of a review, Respondents' analytical procedures and inquiries were appropriate in light of the requirements of AU § 722, and it was not unreasonable for them not to make additional inquiries or employ other procedures.

IV. ULTIMATE CONCLUSIONS

It is concluded that Respondents did not engage in: (1) intentional or knowing conduct, including reckless conduct, that resulted in a violation of professional standards within the meaning of Rule 102(e)(iv)(A); (2) a single instance of highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which they knew, or should have known, that heightened scrutiny was warranted within the meaning of Rule 102(e)(iv)(B)(1); or (3) repeated instances of unreasonable conduct that indicate a lack of competence to practice before the Commission within the meaning of Rule 102(e)(iv)(B)(2). Thus, they did not engage in improper professional conduct within the meaning of Rule 102(e)(ii), and this proceeding must be dismissed.

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on December 28, 2007, as corrected pursuant to Kevin Hall, CPA, Admin. Proc. No. 3-12208 (A.L.J. Jan. 15, 2008) (unpublished).

VI. ORDER

IT IS ORDERED that this administrative proceeding IS DISMISSED.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Carol Fox Foelak
Administrative Law Judge