SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 68431 / December 13, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3427 / December 13, 2012

Admin. Proc. File No. 3-13797

In the Matter of the Application of

WENDY MCNEELEY, CPA
c/o Robert L. Michels, Esq.
Winston & Strawn LLP
35 Wacker Dr.
Chicago, IL 60601

OPINION OF THE COMMISSION

102(e) PROCEEDING

Grounds for Remedial Action

Improper Professional Conduct

Certified public accountant acting as audit manager engaged in improper professional conduct in the audit of the financial statements of a private company and a related fund. *Held*, it is in the public interest to deny the accountant the privilege of appearing or practicing before the Commission for six months.

APPEARANCES:

Robert L. Michels, Scott P. Glauberman, and *J. Malcolm Cox*, of Winston & Strawn LLP, for Wendy McNeeley.

Andrea Wood and *Robert Moye*, for the Division of Enforcement.

Appeal filed: February 11, 2011
Last brief received: May 2, 2011
Oral Argument: November 2, 2011

I.

Wendy McNeeley, a licensed certified public accountant and former audit manager at Ernst & Young ("E&Y"), appeals from the decision of an administrative law judge. The law judge found that McNeeley engaged in improper professional conduct as defined in the Commission's Rule of Practice 102(e)[1] while serving as the audit manager during E&Y's audit of AA Capital Partners, Inc. ("AA Capital"), a registered investment adviser, and AA Capital Equity Fund, L.P. (the "Equity Fund") for the year ended December 31, 2004. The law judge found that McNeeley's improper professional conduct was the result of a single instance of highly unreasonable conduct that resulted in a violation of generally accepted auditing standards ("GAAS") in circumstances in which McNeeley knew, or should have known, that heightened scrutiny was warranted.[2] The law judge determined that, because of this conduct, McNeeley should be denied the privilege of appearing or practicing as an accountant before the Commission for one year. We base our findings on an independent review of the record, except for findings that the parties do not challenge on appeal.

II.

A. AA Capital and its Affiliates

This matter involves McNeeley's audit of a series of transactions through which AA Capital transferred approximately $1.9 million from client trust accounts to its president and co-founder, John Orecchio, purportedly to pay a tax assessment by the Internal Revenue Service. At the time of the audit, AA Capital was headquartered in Chicago, Illinois, and co-owned, equally, by Orecchio and his business partner, Paul Oliver, Jr. In addition to being president, Orecchio served as AA Capital's director and secretary and exercised day-to-day management and control over AA Capital. Oliver served as AA Capital's chairman and treasurer. AA Capital's chief financial officer and chief compliance officer was Mary Beth Stevens, who was responsible for AA Capital's entire accounting function.[3]

AA Capital had several affiliated private equity funds into which AA Capital's clients invested money. The largest of these funds was the Equity Fund, which had approximately $131 million in assets under management as of December 31, 2004. The Equity Fund was governed by an Amended and Restated Limited Partnership Agreement (the "Partnership Agreement"), which gave the Equity Fund's general partner, AA Private Equity Investors Management, LLC

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[1] 17 C.F.R. § 201.102(e)(1)(ii).

[2] GAAS are standards of conduct relating to how auditors should perform an audit. *See SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 n.2, 789 n.4 (9th Cir. 1979). GAAS are generally described in the American Institute of Certified Public Accountants ("AICPA") Codification of Statements of Auditing Standards, hereinafter cited as "AU § __."

[3] None of AA Capital's employees testified at the hearing.

("AA Investors Management LLC"), control over the Equity Fund. Orecchio and Oliver each owned twenty percent of the general partner. The Equity Fund's limited partners were three pension funds, which had their investment commitments deposited into separate bank trust accounts ("Investor Trust Accounts") in the name of each investor. The Equity Fund could call capital from the Investor Trust Accounts for three primary purposes: (i) to make investments; (ii) to pay management fees; or (iii) to pay overhead expenses.

B. E&Y's Audits

E&Y became AA Capital's auditors in 2002, but in 2004, became concerned about whether it had the resources to staff those engagements. This concern caused some delay, but E&Y eventually agreed to audit AA Capital and its affiliated funds for the fiscal years ended December 31, 2003 and 2004. Because of the delay, however, E&Y had to conduct the 2003 and 2004 audits concurrently. AA Capital also requested a June 30, 2005 deadline so that investors would have the financial statements necessary to complete their tax filings. The deadline required E&Y to conduct ten audits simultaneously by June 30, 2005.

E&Y began the audits during the spring and early summer of 2005 and assigned McNeeley as audit manager. The audit team also included an independent review partner, John Kavanaugh; an engagement partner, Gerard Oprins; two audit seniors; and two audit staff. McNeeley was twenty-nine-years old at the time and had been licensed as a certified public accountant for approximately eight years. As audit manager, McNeeley reported to the engagement partner, Oprins, but McNeeley was responsible for overseeing day-to-day audit planning and executing audit strategy. McNeeley also supervised the audit staff and reviewed audit workpapers in significant risk areas.

As part of the planning process, E&Y's audit team determined not to rely on AA Capital's internal controls because E&Y determined those controls to be "ineffective" for purposes of E&Y's audit. McNeeley explained that this determination was primarily due "to the lack of sophistication with the client's accounting function and that they kept all their books and records in Excel format." This determination meant that E&Y's audit would need to test all account balances substantively and verify (or "vouch") all capital calls and distributions.

McNeeley also expressed concern early in the audit process about meeting the June 30 deadline because of staffing constraints, another audit engagement McNeeley was conducting by herself, and a two-week vacation McNeeley intended to take (and did take) starting May 20, 2005. McNeeley, for instance, wrote in an e-mail to Oprins in May 2005 that she was "very concerned about the wrap up of this engagement." In a subsequent email in June 2005, McNeeley again wrote "to convey that the June 30th deadline will be challenging to meet," but added that she believed "that we will be able to meet the June 30 deadline" and "just wanted to prepare Mary Beth [Stevens]" for the fact "that things may be pulled together at the last minute."

C. Discovery of Orecchio's Purported Tax Loans

Sometime during the audit, the E&Y team noticed that AA Capital's accounts receivable schedule (the "Receivable Schedule")[4] listed four cash transfers to Orecchio (collectively, the "Transfers"). The Receivable Schedule described the transfers as "John – tax payment" and totaled approximately $1.92 million. The Transfers were spread over approximately six months, at uneven intervals, in varying amounts, and with slightly different structures:

- On May 19, 2004, $987,000 was transferred from two Investor Trust Accounts to AA Capital's primary bank account. The same day, $602,150 was transferred from AA Capital's primary bank account to Orecchio's personal bank account.
- On August 2, 2004, $190,000 was transferred from three Investor Trust Accounts to AA Capital's primary bank account. The same day, $190,154 was transferred from AA Capital's primary bank account to Orecchio's personal bank account.
- On September 20, 2004, $600,000 was transferred from three Investor Trust Accounts to AA Capital's primary bank account. The same day, $579,000 was transferred from AA Capital's primary bank account to Orecchio's personal bank account.
- On November 5, 2004, $550,000 was transferred from three Investor Trust Accounts to the Equity Fund's bank account. The same day, $550,000 was transferred from the Equity Fund's bank account to Orecchio's personal bank account.[5]
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On or around May 7, 2005, an E&Y audit staff member, Corina Rojas, had a conversation with Stevens about the Transfers. Rojas documented the conversation with a note on the Receivable Schedule:

> Per conversation w/ Mary Beth Stevens, CFO, all of the funds held under AA Capital Inc. had not finalized their audits, tax filings, and therefore John Orrechio [sic], (managing member) did not have a final tax return draft that included taxable income w/ set figures. Therefore he had to estimate his tax liability [and] made a payment to the IRS for 1,921,150 . . . . The 1,921,150 is essentially a loan made to John Orrechio [sic]. Mary Beth Stevens expects to receive payment from either Mr. Orrechio [sic] or the IRS after taxes are finalized.

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[4] McNeeley explained that the Receivable Schedule was prepared by Stevens and contained a list "of disbursements from the entity and gives further detail and break out of what those amounts related to."

[5] The parties stipulated to these details, although an e-mail dated June 16, 2005, from Stevens to McNeeley, described the Transfers in slightly different amounts: $596,129 (May 19, 2004); $188,100 (August 2, 2004); $573,210 (September 20, 2004); and $544,500 (November 5, 2004).

Rojas, who did not testify, further noted on the Receivable Schedule that Orecchio's co-owner, Oliver, had also received a tax advance – for $18,228.

D. McNeeley's Audit Steps Regarding the Transfers

McNeeley testified that, "at some point," she saw the Receivable Schedule listing the four transfers to Orecchio. She could not remember, however, precisely when she first learned of the Transfers, explaining that "it is hard for me to remember exactly when I learned things throughout the audit." McNeeley recalled meeting with Stevens to discuss the Receivable Schedule, but could not recall when that meeting occurred. McNeeley remembered asking Stevens during their meeting to provide "any and all documentation that she had regarding the tax advances." According to McNeeley, Stevens responded to the request for documents by directing McNeeley to the tax advance amounts listed in the Receivable Schedule. McNeeley added that she and the audit team "also had other documentation that we had previously been provided that also reflected and supported [the Transfers]."

The first document was a general ledger. McNeeley explained that the ledger was a document prepared by Stevens reflecting "all transactions going through the company for a set period of time." The ledger showed the detail of the individual purported tax payments, dollar amounts, and dates paid.

The second document was a management representation letter (which was actually two documents: one each for AA Capital and the Equity Fund). The letters were signed by Stevens and Orecchio and represented to E&Y that AA Capital's and the Equity Fund's accounting records were complete and accurately reflected all transactions. The management letter for the Equity Fund included a general representation that all related-party transactions were properly recorded or disclosed in the financial statements. Neither management representation letter, however, explicitly mentioned the Transfers.

The third document was the Partnership Agreement, which allowed tax-related transfers in certain situations. Section 7.3.1 of the agreement provided that "if net income of the [Equity Fund] is allocated to [its] Partners in any fiscal year," then the Equity Fund could make "tax distributions" to satisfy any tax liability such partner "would actually have incurred."[6] Here, however, the Equity Fund had a net investment loss in both 2003 and 2004, and neither of the other two parties involved in the Transfers (Orecchio and AA Capital) were partners in the Equity Fund.

McNeeley testified that she "read through" the Partnership Agreement at the beginning of the audit and "gained an understanding of all the significant provisions within the limited partnership agreement." She could not recall, however, whether she reviewed the Partnership Agreement when evaluating the Transfers. As she explained, "I don't have a specific recollection of looking at [the Partnership Agreement] while . . . looking at the accounts receivable schedule,

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[6] The Partnership Agreement's Section 7.3.3, which was subject to Section 7.3.1, similarly provided for advances to partners to satisfy estimated taxes.

but I had previously looked at the [Partnership Agreement] at the beginning of field work and had an understanding of the provision allowed for in the agreement."

When asked during the hearing, McNeeley also testified that she and the audit team never sought nor received any third-party confirmation regarding the Transfers, such as documentation from the IRS evidencing a tax liability assessment. McNeeley also could not remember whether she ever asked about Orecchio's ability to repay the Transfers. As McNeeley explained, "we had no reason to question the collectibility of the receivable from John Orecchio to AA Capital Partners. We understand him to be a successful wealthy business man. He had capital in the [E]quity [F]und as well as investments and various other funds." McNeeley added, "Based on my recollection of the transaction, we understood it to be an erroneous tax liability that had been assessed to John Orecchio; and therefore, he anticipated settlement with the IRS and was going to use that to repay it."

McNeeley also could not recall contacting the E&Y tax department for any reason. E&Y's tax department prepared AA Capital's tax returns at the time of the audits and, therefore, likely could have confirmed whether AA Capital had reported income in 2003 or 2004 on which Orecchio would owe taxes. McNeeley testified, however, that she "d[id]n't know why I would go and inquire [of] the E&Y tax team . . . when the tax liability that John Orrechio [sic] received advances for related to his personal tax return . . . and our tax department wouldn't have all the information necessary to make the evaluation of his personal tax position."

McNeeley testified at various points during the hearing that she was comforted by her understanding that Oliver and Orecchio "would have full knowledge about each other's tax advances." McNeeley could not recall, however, ever confirming whether Oliver actually knew about the Transfers. In fact, McNeeley could not recall whether she or any other member of the audit team ever spoke with Orecchio or Oliver about any aspect of the Transfers. McNeeley instead testified that she "understood" that the two partners "would have full knowledge of each other's tax advances" and that she based this understanding "on Paul Oliver being the treasurer of the company and having full access to the records." McNeeley later added that Oliver "had the opportunity to become aware of such transaction and had a fiduciary . . . obligation as a co-owner of AA Capital Partners to be aware of all the transaction [sic] and ongoing of the business [sic]."

Near the end of the audit, McNeeley went on vacation for approximately two weeks, beginning May 20, 2005. After her return, McNeeley e-mailed Stevens "to get clarification as to exactly what the tax liability related to." In her initial email, sent June 7, 2011, McNeeley expressed confusion to Stevens about who owed the tax liability and whether any payment had been made. McNeeley, for example, asked Stevens to clarify that accruals "labeled as 'John's Tax Payment' . . . are accruals for the Corporation's tax payments and not personal tax liabilities of the Shareholders." McNeeley also asked "when are the actual payments expected to be made[?]"

Stevens responded that Orecchio had been "dinged by the IRS and incurred multiple fees and tax payments." Stevens added that most of the supposed tax assessment amounts were not correct, but could not be settled with the IRS until the audit and tax work were completed.

Stevens explained, "Payments for which [Orecchio] is truly liable for he will pay and a majority, if not all, will be refunded back to him which he will then repay the company."

McNeeley expressed continued confusion in a follow-up email about what she described as "these hefty tax assessments." McNeeley wrote to Stevens that "it's my understanding that no money has actually been paid from or received by AA Capital in relation to the payment of John [Orecchio]'s taxes," and asked "if it is proper to present a liability on the books of AA Capital for which AA Capital does not currently have obligation to pay." Stevens wrote back to clarify that AA Capital was owed an accounts receivable from Orecchio and, in turn, AA Capital owed an accounts payable to the Equity Fund.

On the same day as her email exchange with Stevens, McNeeley documented her understanding of the Transfers with a note in the workpapers:

> [T]he Equity fund made approx. [$]1,921,304 of tax payments for John Orrechio [sic] during 2004. [T]he Equity fund has set up a receivable from AA Capital Partners for reimbursement of this amt. E&Y verified that AA Cptl Ptnrs has a reciprocal payable balance to Equity. E&Y also noted that AA Cptl has an offsetting receivable balance from John Orrechio [sic]. Appears proper.

Oprins testified that he saw McNeeley's note, but he could not recall "one way or the other" whether McNeeley ever discussed the Transfers with him. Oprins could recall only that McNeeley kept him informed about what was happening during the audits, but not the specific audit steps taken regarding the Transfers or whether he had discussed the Transfers with the audit team.

E. E&Y's Subsequent Review Testing

As part of the 2004 audit, the E&Y audit team conducted "subsequent review testing" of transactions that occurred after the 2004 year end. E&Y's workpapers showed that the audit team looked at AA Capital's cash receipt and disbursement records for "significant" or "unusual" items that may have occurred between January 1, 2005 and March 31, 2005. McNeeley wrote in the workpapers that "no unusual items" were uncovered during this subsequent review.

AA Capital's 2005 accounts receivable schedule, however, showed that AA Capital made nine more disbursements to Orecchio in January and February 2005, totaling $482,000. The 2005 accounts receivable schedule described these transfers as "J.O. taxes," "JO Tax Distrib," or "JO Tax Dist." The record is not clear, however, whether McNeeley saw these subsequent transfers. The only document in the record that lists the subsequent transfers is the 2005 accounts receivable schedule. That document, however, includes entries dated as late as December 31, 2005 and therefore could not have existed at the time McNeeley was completing the audit in June 2005.

F. The 2004 Financial Statement

E&Y completed the audits by the end of June 2005 and issued unqualified audit opinions for AA Capital's and the Equity Fund's 2004 financial statements. E&Y's audit opinion represented that E&Y had conducted its audit in accordance with GAAS and that the audit provided a reasonable basis for E&Y's opinion that AA Capital's and the Equity Fund's financial statements fairly presented the firms' financial positions, results of operations, and cash flows.[7]

The audited financial statements provided no specifics about the $1.92 million tax advance to Orecchio. Instead, AA Capital's 2004 financial statements disclosed only that the company had $2.534 million in "[f]ee and accounts payable" and $2.251 million in "[a]ccounts receivable from affiliates." The notes to AA Capital's financial statements also provided no mention of transfers to Orecchio. The notes instead discussed only that the company had paid $264,176 in "certain reimbursable expenses" for several of AA Capital's related funds. The Equity Fund's financial statements similarly listed a $1.92 million "[a]ccounts receivable from AA Capital Partners, Inc.," with no other details such as the terms or manner of settlement.

E&Y's internal GAAP Disclosure Checklist stated that "[n]otes or accounts receivable from officers, employees or affiliated companies must be shown separately and not included under a general heading such as notes or accounts receivable." In response to this item, McNeeley checked a box indicating "not applicable." McNeeley explained that she checked "not applicable" because she believed the requirement was limited to making sure that "accounts receivable with related parties is not grouped in with other accounts receivables from trade creditors and that was not the case in either one of these financial statements."

G. Discovery of Orecchio's Fraud

AA Capital engaged E&Y to audit the company and its related funds again the following year, 2005. Jennifer Aquino replaced McNeeley as the audit manager because McNeeley was on maternity leave. Most of the 2005 E&Y audit team otherwise remained the same.

During the 2005 audit, Aquino asked Stevens for documentation supporting the tax transfers to Orecchio, but never received anything in return. Aquino testified that the E&Y audit team had several internal meetings regarding the transfers and sent Orecchio an e-mail, but the record provides no indication that Orecchio ever responded. Those steps, Aquino recalled, were

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[7] The audit opinion for AA Capital's financial statements included a disclaimer that AA Capital's policy was to prepare its financial statements on a tax basis of accounting. The financial statements, the audit opinion explained, were not intended to be presentations in conformity with generally accepted accounting principals ("GAAP"). Despite this disclaimer, Oprins and McNeeley both acknowledged that GAAP disclosure requirements for related-party transactions were the same no matter whether the financial statements were tax-based or GAAP-based. The audit opinion for the Equity Fund's financial statements did not include a tax basis disclaimer.

"the best that we felt we could do at that time." She explained that, because the audit team "didn't have anything to audit," they could only wait to receive something more from AA Capital. Aquino also learned during the audit that, by the end of 2005, the tax transfers to Orecchio had grown to $5.7 million. As McNeeley's expert witness testified, AA Capital's financial statements expressly identified the Transfers as "accounts receivables," which indicated that the Transfers were short-term advances repayable within one year. Aquino, therefore, found it significant that the 2004 transfers not only still existed on AA Capital's books in 2005, but had, in fact, increased.

The audit team eventually decided that they would not continue with the 2005 audit until Orecchio paid back the "tax loan" and E&Y had received enough documentation to audit the transfer balance. On June 30, 2006, Oprins informed Stevens and Orecchio that E&Y would not release its 2005 audit opinions until Orecchio repaid the transfers. The E&Y audit team also raised a "going concern" issue regarding AA Capital's ability to fund its operations. The audit team was unable to resolve these issues, and E&Y never issued its 2005 audit reports.

In August 2006, the Commission conducted a "for cause" on-site examination of AA Capital to investigate a tip from the U.S. Department of Labor about a kickback scheme. During the examination, Commission staff learned that Orecchio had misappropriated approximately $5 million through a fraudulent tax-loan mechanism. In September 2006, the Commission filed a complaint in U.S. District Court against AA Capital and Orecchio. The complaint alleged that AA Capital and Orecchio misappropriated at least $10.7 million from AA Capital's advisory clients, and the U.S. District Court placed a receiver over AA Capital.[8] The U.S. Department of Justice subsequently brought criminal charges against Orecchio in 2009 for wire fraud and theft of funds from an employee benefit plan. Orecchio pleaded guilty in February 2010, and a U.S. District Court sentenced Orecchio to more than nine years in prison.[9] The Commission also instituted administrative proceedings against Stevens and Oliver for their involvement in the fraud. Stevens and Oliver eventually consented to, among other things, a bar and twelve-month suspension, respectively; civil penalties; and a cease-and-desist order.[10]

H. Rule 102(e) Administrative Proceeding

In March 2010, the Commission issued an Order Instituting Proceedings ("OIP") against McNeeley and her supervisor, Gerard Oprins, in connection with their audit of AA Capital. The OIP charged McNeeley and Oprins with engaging in improper professional conduct as defined in Rule 102(e) "in that their conduct constituted (A) intentional or knowing conduct, including

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[8] *SEC v. AA Capital Partners, Inc.*, No. 06-C-4859 (N.D. Ill. Sept. 8, 2006).

[9] *United States v. Orecchio*, No. 09-CR-622 (N.D. Ill. 2010).

[10] *Mary Beth Stevens*, Investment Advisers Act Rel. No. 2973 (Jan. 5, 2010), 97 SEC Docket 24420; *Paul W. Oliver, Jr.*, Advisers Act Rel. No. 2903 (July 17, 2009), 96 SEC Docket 19124.

reckless conduct, that resulted in a violation of the applicable professional standards, or in the alternative, (B) negligent conduct, consisting of a single instance of highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which Respondents knew, or should have known, that heightened scrutiny was warranted." After an eight-day hearing, an administrative law judge issued an initial decision finding that McNeeley's actions did not constitute reckless conduct, but did constitute highly unreasonable conduct in circumstances warranting heightened scrutiny that resulted in a violation of the applicable professional standards. The law judge found that Oprins also violated the applicable professional standards, but that his actions were neither reckless nor highly unreasonable. McNeeley appeals the law judge's decision.[11]

III.

Rule of Practice 102(e) permits us to censure or deny (either permanently or temporarily) the privilege of appearing or practicing before the Commission to persons found to have engaged in improper professional conduct. The rule defines three classes of "improper professional conduct" for accountants, but this appeal concerns only one: whether McNeeley engaged in "a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted."[12] We find, for the reasons below, that McNeeley engaged in such improper professional conduct.

A. Heightened Scrutiny Was Warranted

Our Rule 102(e) analysis first considers whether the Transfers warranted heightened scrutiny. Under Rule 102(e), "heightened scrutiny" is warranted "when matters are important or material, or when warning signals or other factors should alert an accountant" to a heightened risk.[13] These factors were clearly present here.

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[11] Because the law judge's decision regarding Oprins was not appealed, the only issue before us on appeal is whether McNeeley engaged in improper professional conduct. *See Gerard A.M. Oprins, CPA*, Securities Exchange Act Rel. No. 63931 (Feb. 18, 2011) (giving notice, "pursuant to Rule 360(d) of the Commission's Rules of Practice, that the initial decision of the administrative law judge has become the final decision of the Commission with respect to Gerard A.M. Oprins").

[12] 17 C.F.R. § 201.102(e)(1)(iv)(B)(*1*). The other two classes of improper professional conduct are "intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards;" and "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)(A), (e)(1)(iv)(B)(*2*).

[13] *Amendment to Rule 102(e) of the Commission's Rules of Practice* ("*Amendment to Rule 102(e)*"), 63 Fed. Reg. 57,164, 57,168 (Oct. 26, 1998).

First, the Transfers were related-party transactions, which we and the courts have repeatedly held require heightened scrutiny.[14] The reason for this, the D.C. Circuit has explained, "is apparent: Although in an ordinary arms-length transaction, one may assume that parties will act in their own economic self-interest, this assumption breaks down when the parties are related. A company that would perform a thorough credit-risk assessment before extending a loan might not do so if the loan were to one of its officers or directors."[15] That is the case here. AA Capital essentially extended a loan from clients' trust accounts to Orecchio, who was not only an officer and director of AA Capital, but also a founder and co-owner. Transactions involving such strong related-party relationships, the D.C. Circuit has explained, alert auditors that a firm may not have thoroughly vetted those transactions and that, as a result, heightened scrutiny is needed – exactly the case that faced McNeeley.[16]

Second, the Transfers were plainly material, which we have also stated triggers heightened scrutiny.[17] McNeeley counters that materiality "is irrelevant" because, she contends, auditors are concerned only with material transactions. She claims that to hold that materiality warrants heightened scrutiny would therefore mean that every transaction would warrant heightened scrutiny. She argues that multi-million dollar tax liabilities are not unusual for private equity firm partners and do not necessarily require heightened scrutiny. Even if we accepted this latter proposition regarding the absolute amount of the tax liabilities, the Transfers here were more than 100 times greater than a transfer to Orecchio's equal partner in a year in which the Equity Fund had no net income.[18] Even McNeeley described the $1.9 million transfers combination warrants heightened scrutiny.[19]

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[14] *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005) (citing *Howard v. SEC*, 376 F.3d 1136, 1149 (D.C. Cir. 2004)) (noting that related-party transactions "are viewed with extreme skepticism in all areas of finance"), *aff'g James Thomas McCurdy, CPA*, 57 S.E.C. 277 (2004); *see also Gordon v. Comm'r*, 85 T.C. 309, 326-27 (1985) (explaining "heightened" skepticism for related-party transactions); AU § 334 (recognizing need for care in the examination of material related-party transactions).

[15] *McCurdy*, 396 F.3d at 1261.

[16] *McCurdy*, 396 F.3d at 1264 ("The related-party interest underlying the transaction was not minor: Bagwell was the founder and CEO of the fund, a trustee, and its investment advisor.").

[17] *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,168 (stating that heightened scrutiny is warranted "when matters are important or material").

[18] *Cf. McCurdy*, 396 F.3d at 1264 (affirming Commission's finding of recklessness where auditor failed to investigate adequately a related-party receivable that "was nearly ten times the amount of the GAAS-dictated materiality threshold").

[19] *See McCurdy*, 57 S.E.C. at 295 (finding heightened scrutiny to be warranted where, among other things, the receivable at issue "arose from a related party transaction" and

(continued...)

Finally, McNeeley argues that the material, related-party nature of the Transfers cannot provide a basis for finding that the Transfers warranted heightened scrutiny because, she claims, the Division failed to make such allegations in the OIP. To the contrary, however, the OIP expressly alleged that "McNeeley identified Orecchio's 'tax loan' as a related party transaction, [but] failed to apply heightened scrutiny or perform any additional audit steps to evaluate it." Moreover, the standard for determining whether notice is adequate is whether "the respondent 'understood the issue' and 'was afforded full opportunity' to justify [her] conduct during the course of the litigation."[20] We find that McNeeley, who has been represented by counsel throughout these proceedings, adequately understood the allegation that the Transfers warranted heightened scrutiny because of their material, related-party nature and that she had ample opportunity to defend herself against those allegations.

B. McNeeley Violated Applicable Professional Standards

Our analysis of whether McNeeley engaged in improper professional conduct next addresses whether McNeeley violated applicable professional standards. Here, we find that McNeeley violated three professional standards: (i) exercising due professional care, (ii) obtaining sufficient competent evidence, and (iii) rendering an accurate audit report.[21]

1. Failure to Exercise Due Professional Care

GAAS require auditors to exercise due professional care when conducting an audit and preparing a report.[22] Under this standard, auditors must maintain an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence."[23] Until an auditor obtains an understanding of the business purpose of material related-party

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19 (...continued)
was "clearly material"); AU § 334.07 ("The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity."); *cf. McCurdy*, 396 F.3d at 1263-64 (finding that auditor's failure to investigate material, related-party transaction was reckless under Rule 102(e)).

20 *Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 262 (D.C. Cir. 1979).

21 AU § 230.01 (professional care); AU § 326.22 (sufficient competent evidential matter); AU § 508.07 (accurate audit report).

22 AU § 230.01 ("Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.").

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

transactions, her audit is not complete.[24] Here, numerous red flags and other irregularities surrounded the Transfers – anomalies that should have triggered McNeeley's professional skepticism and led her to investigate further at that point. Instead, McNeeley did essentially nothing, and an unqualified audit opinion was eventually issued. As explained below, this failure to investigate fell well below the necessary level of professional care.

The first, and most glaring, red flag that McNeeley failed to investigate properly involved the Equity Fund's Partnership Agreement. That agreement contemplated tax-related transfers only for partners of the Equity Fund. Neither Orecchio nor AA Capital, however, was a partner in the fund. The Partnership Agreement also contemplated tax-related transfers only for years in which the fund allocated net income to such partners. The Equity Fund, however, had a net investment *loss* in both 2003 and 2004.

Even a relatively casual understanding of the Partnership Agreement, therefore, should have, at a minimum, alerted McNeeley that the agreement's terms did not accord with what she knew about the Transfers. As an auditor, McNeeley was responsible for reconciling these discrepancies, and verifying that the Equity Fund's governing documents allowed the Transfers was perhaps the most basic auditing step McNeeley could have taken. The workpapers, however, contain no indication that she made any effort to square the Partnership Agreement with the Transfers, and McNeeley herself testified that she could not remember whether she reviewed the Partnership Agreement subsequent to learning of the Transfers. Instead, McNeeley claims only that "she was familiar with private equity partnership agreements and the typical provisions within such agreements, and based on her review of the Partnership Agreement at the outset of the audit, she understood its provisions." Given the centrality of the Partnership Agreement in determining the permissibility and appropriate reporting of the Transfers, it was incumbent upon McNeeley to have a better understanding of the Partnership Agreement than she did. The lack of evidence that McNeeley performed any follow-up regarding the Partnership Agreement leads us to one of two conclusions: either McNeeley did not review the agreement sufficiently to notice and understand the obvious red flags or she noticed the red flags, but did nothing about them. Either is a failure to exercise due care.

In her appeal, McNeeley disputes that the Partnership Agreement contained any red flags, because, she claims, the agreement in fact allowed for tax distributions and advances. McNeeley does not explain, however, how the agreement actually allowed for the Transfers, other than to point to what she calls the "common sense" argument that the "very reason that Mr. Orecchio chose to disguise his misappropriations as a tax advance was that the Partnership Agreement clearly allows for tax advances under the circumstances here. If it had not, he would not have used the Partnership Agreement to justify withdrawing the money." McNeeley's generic, unsupported, after-the-fact assertion that the Partnership Agreement allowed for tax distributions and advances in certain situations – situations that, on their face, did not apply here – is not a foundation on which one may properly base an audit. Moreover, McNeeley's contention that it is "common sense" that a fraudster's cover-up would conform to the governing documents is contradicted here by the audit evidence of the Partnership Agreement's provisions, and underscores how little attention she paid to that evidence.

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[24] AU § 334.09(a).

The inconsistencies between the Transfers and the Partnership Agreement were not the only red flags that McNeeley failed to investigate. Stevens gave McNeeley and her audit team inconsistent explanations for why Orecchio needed the Transfers. The first explanation Stevens gave was that Orecchio needed the Transfers because he "did not have a final tax return draft [and] [t]herefore he had to estimate his tax liability and make a payment to the IRS." This explanation suggests that Orecchio's alleged tax liability was based on his own estimate. Later, however, Stevens told McNeeley that Orecchio had been "dinged by the IRS and incurred multiple fees and tax payments." This explanation suggests that Orecchio's alleged tax liability was based on an IRS calculation (which Orecchio believed was incorrect).[25] The record again contains no evidence that McNeeley exercised appropriate care by attempting to reconcile these inconsistencies.

McNeeley defends her failure to investigate by arguing that Stevens's explanations were not, in fact, inconsistent. As McNeeley testified, she understood the Transfers to be "a tax assessment that was assessed to Mr. Orrechio [sic] based on his estimated taxes[, which] he believed . . . was erroneous in nature because it was not based on final numbers." McNeeley, however, points to no evidence supporting this after-the-fact rationalization that Orecchio had incurred some sort of estimated, erroneous taxes. To the contrary, McNeeley's convoluted explanation of the situation raises its own set of questions.[26] How, for example, did Orecchio estimate a nearly $2 million tax liability for a year in which the Equity Fund had no net investment income? How did Orecchio's erroneous tax estimate, which the workpapers indicated was related to a failure by "all of the funds held under AA Capital" to finalize their audits and tax filings, explain why Orecchio withdrew money from only the Equity Fund? How does an erroneous tax assessment explain why the Transfers, even when taken out of the Equity Fund, were not always drawn from the same client trust accounts? How does an erroneous tax assessment explain why the Transfers took place on multiple dates, at uneven intervals, and in varying amounts? Again, the record contains no indication that McNeeley explored these questions. Instead, McNeeley simply accepted management's explanations at face value.

An additional, obvious question would have been how not having "final numbers" led Orecchio to estimate taxes that were more than 100 times larger than what his equal partner Oliver paid. McNeeley argues that Orecchio's disproportionately large tax liability was not suspicious because she was told that his tax liability was the result of an erroneous assessment that McNeeley contends "would not bear any relation to the amount of a correct tax liability or the amount of someone else's correct tax liability." In support, McNeeley points to an E&Y tax partner's testimony in which he theorized that the IRS could make any variety of mistakes that could result in large tax discrepancies, such as entering incorrect numbers on one's tax files. This

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[25] In yet a third explanation, a managing director at AA Capital told Oprins that AA Capital's partners "were incurring substantial interest and penalties as a result of late filings of tax returns." The record does not indicate that McNeeley was aware of this explanation.

[26] *Cf. Michael J. Marrie, CPA*, 56 S.E.C. 760, 784 (2003) (rejecting "an after-the-fact justification for [respondents'] failure to exercise the required degree of professional care"), *rev'd on other grounds*, 374 F.3d 1196 (D.C. Cir. 2004).

hypothetical example, however, is inconsistent with the reason for the Transfers that McNeeley was initially given: that someone erroneously estimated Orecchio's taxes because of not having final tax information. McNeeley's explanation for her lack of suspicion about Orecchio's disproportionate tax liability thus highlights the difference between the two explanations she was given. The record contains no evidence that McNeeley ever investigated the reasons for these differing explanations.

The record also contains no evidence that McNeeley ever attempted to verify Orecchio's ability to repay the tax advance. McNeeley testified only that she could not recall whether she inquired into Orecchio's ability to pay, and added that "we had no reason to question the collectibility [because] [w]e understood him to be a successful wealthy businessman who had capital in AA Capital Partners, Inc. plus investments in various other funds." McNeeley's assumption about Orecchio, however, again lacked support. The workpapers contained no evidence that McNeeley inquired into Orecchio's overall financial condition. What were these "various other funds" worth? Were these investments liquid enough to satisfy the amount of the short-term loans? What were his liabilities? Were his assets encumbered by any debt? Did Orecchio have sufficient liquid assets to repay the loan in a time period consistent with the loan being classified as a short-term receivable? The workpapers contain no evidence that McNeeley ever investigated these questions.[27] Stevens also told McNeeley that the IRS was likely to reimburse Orecchio for the supposedly erroneous tax payments, but the workpapers contain no evidence supporting that claim either.

Ultimately, because McNeeley never investigated, let alone reconciled, these various inconsistencies, McNeeley's various hypothetical explanations for the Transfers remained just that: hypotheticals. Pursuant to GAAS, however, "[i]f a representation made by management is contradicted by other audit evidence," an auditor may not simply hypothesize, but "should investigate the circumstances, and consider the reliability of the representation made."[28] That was repeatedly the case here. But instead of investigating, McNeeley did essentially nothing.[29]

McNeeley contends that any follow-up regarding the Transfers would have been futile because, she claims, individuals at AA Capital were engaged in collusive fraud. In support, she notes that Orecchio had forged two IRS notices that she claims show that "AA Capital's

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[27] *Cf. Gregory M. Dearlove, CPA*, Exchange Act Rel. No. 57244 (Jan. 31, 2008), 92 SEC Docket 1867, 1887 (rejecting auditor's reliance on family's ability to repay loan where auditor did not determine whether family's assets were encumbered by other debts and auditor "saw no financial statements or other proof of the family's financial condition other than local media reports that the [family members] 'were billionaires'"), *petition denied*, 573 F.3d 801 (D.C. Cir. 2009).

[28] AU § 333.04.

[29] Our identification of examples of steps that McNeeley could have taken, but did not, is not intended to imply that she necessarily was required to take all of these steps to fulfill her professional duties. Rather, faced with multiple red flags, McNeeley had an obligation to investigate more than she did.

management had plainly prepared a series of false documents to dole out to the auditors as necessary." She acknowledges that the record contains no evidence that the audit team ever saw the notices, but hypothesizes that "[m]ore demands [from McNeeley] would have been met with more false documents." Individuals at AA Capital were indisputably engaged in fraud, and E&Y's auditors were plainly not receiving accurate information about the Transfers. It is thus possible that, no matter the steps McNeeley took, individuals at AA Capital would have continued to hide the Transfers' true nature. The gravamen of the charge against McNeeley, however, is not her failure to uncover the fraud itself, but her failure to adhere to GAAS during the audit. An auditor, we have explained, "is not a guarantor of the accuracy of financial statements of public companies, but the Commission and the investing public rely heavily on auditors to perform their tasks in auditing public companies 'diligently and with a reasonable degree of competence.'"[30] Therefore, although "[w]e do not know whether [the] fraud would have been uncovered had [McNeeley] fulfilled [her] professional duties in conducting the audit, . . . that is not relevant to our inquiry."[31]

McNeeley also defends her conduct by challenging whether the Division met its burden of proving that McNeeley, in fact, failed to take the various follow-up auditing steps described above (such as reviewing the Partnership Agreement a second time in connection with the Transfers or verifying Orecchio's tax liability). McNeeley asserts that the only evidence against her is her own failure to remember whether she took the steps described above and the workpapers' failure to mention whether she took such steps. She claims that the Division, by relying on such evidence, is essentially faulting her for not memorializing "every fact gathered, conversation held, or procedure performed in the course of an audit."[32] McNeeley's argument, however, misconstrues her auditing responsibilities and the Division's case against her. Understanding the red flags described above was crucial to understanding, and approving the accounting treatment of, the underlying Transfers. As we have stated before, "[w]e consider the absence of work papers to be evidence that the audit team did not devote substantial, if any,

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[30] *See Marrie*, 56 S.E.C. at 795 (quoting *Touche Ross & Co. v. SEC*, 609 F.2d 570, 581 (2d Cir. 1979)).

[31] *See Marrie*, 56 S.E.C. at 794-95; *see also Michael S. Hope, CPA*, 49 S.E.C. 568, 606 (1986) (noting that the Commission has repeatedly held that "being lied to" is not an automatic defense to charges of improper professional conduct); *Touche Ross & Co.*, 45 S.E.C. 469, 469 (1974) (finding that "deception . . . did not relieve Touche of its responsibility to perform its audits in conformity with generally accepted auditing standards").

[32] McNeeley frames this argument as an error by the law judge to apply the proper burden of proof. McNeeley, in fact, frames much of her appeal in terms of errors by the law judge. Our *de novo* review, however, cures any error that the law judge may have made. *See Robert M. Fuller*, 56 S.E.C. 976, 989 n.30 (2003), *petition denied*, 95 F. App'x 361 (D.C. Cir. 2004). The law judge's opinion thus ceased to have any force or effect once McNeeley filed her petition for review. *See Fundamental Portfolio Advisers, Inc.*, 56 S.E.C. 651, 679 n.44 (2003); 17 C.F.R. § 201.360(d), (e).

effort to review the areas in question."[33] And here, McNeeley does not dispute that the workpapers do not explain, or even mention, the red flags described above or that the workpapers fail to document any steps she may have taken toward understanding or reconciling the red flags.

In the end, despite a variety of significant red flags surrounding the Transfers, McNeeley and the E&Y team verified only the amount of those Transfers ($1.9 million). On almost every other aspect, McNeeley had only vague, unsupported, and often contradictory management representations, which raised more questions than they answered. McNeeley's failure to follow up on such obvious, outstanding issues was a clear failure to exercise due care.

2. Failure to Obtain Sufficient Competent Evidential Matter

McNeeley's lack of due care also led to the related auditing failure of not obtaining sufficient competent evidential matter. GAAS require auditors to obtain evidence sufficient to afford a reasonable basis for an opinion with respect to the financial statements under review.[34] GAAS explain that "[t]he amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his or her professional judgment after a careful study of the circumstance in the particular case."[35] GAAS also warn that management representations "are not a substitute for the application of th[e] auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit," and auditors may not become satisfied with less than persuasive evidence merely because they believe that management is honest.[36] These warnings were all the more urgent in the context of auditing a transaction requiring heightened scrutiny because it was a material, related-party transaction involving a member of management. McNeeley's audit did not conform to these standards.

If the Transfers were, as Stevens represented them to be, related to a tax liability, then a variety of obvious evidential material about the Transfers should have been readily obtainable, such as IRS-related correspondence, filings, or checks. But McNeeley did not require Stevens to produce any of this material. Nor did McNeeley question Stevens's failure to produce such documents when McNeeley asked Stevens to provide all documents related to the Transfers – a non-response that should have raised its own set of questions. McNeeley relied only on a receivable schedule, a general ledger, and management representation letters.[37] These documents told McNeeley little about the Transfers other than the amount that was transferred to Orecchio. In fact, McNeeley's June 7 emails to Stevens showed that McNeeley could not tell from those

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[33] *Dearlove*, 92 SEC Docket at 1883 n.39 (noting that "workpapers are ordinarily the foundation on which support for audit conclusions is demonstrated").

[34] AU § 326.22.

[35] *Id.*

[36] AU §§ 333.02, 230.09.

[37] McNeeley also claims to have relied on the Partnership Agreement, but, as discussed, that document did not support the validity of the Transfers.

documents such basic information as whether the Transfers related to a personal or corporate tax liability, whether any payment had yet been made, or who, if anyone, made such payment. Nor did the materials on which McNeeley relied answer the various questions discussed above, such as why the Transfers came only from the Equity Fund or how an erroneously estimated tax liability could be nearly $2 million, which was more than 100 times more than his equal partner Oliver's liability, in a year in which the Equity Fund had no net investment income. McNeeley's correspondence with Stevens was a good starting point for answering these questions, but Stevens's responses about Orecchio's being "dinged by the IRS" were still only unsubstantiated management representations, lacked detail, and arguably contradicted Stevens's earlier explanation about the Transfers' being related to estimated taxes.

In fact, other than the Partnership Agreement, the evidential materials McNeeley obtained were all representations or internal accounting documents generated by management. As GAAS expressly warn, evidential matter regarding related-party transactions, such as the Transfers, "should extend beyond inquiry of management."[38] GAAS are even more specific concerning the audit of related-party transactions involving an uncollected balance (the case here). GAAS identify certain sources an auditor should consider when testing an uncollected balance from a related party, including "audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies."[39] Other than looking at AA Capital's past financial statements, however, the record does not show that McNeeley consulted any of these materials.

To the contrary, McNeeley effectively admits to not seeking certain evidential material (such as tax documents or cancelled checks) when she argues that it was not her job to investigate the legitimacy of Orecchio's ultimate use of the Transfers. McNeeley acknowledged during her testimony, however, that it was "a typical procedure" for an audit team to seek confirmation of a transaction from third parties. McNeeley testified that she did not do that in this case because she "essentially already got" such confirmation by obtaining the management representation letters signed by Orecchio. She explained that "the only party related to the transaction from AA Capital to John Orrechio [sic] would be John Orrechio [sic]. And so we did obtain a confirmation from him in the form of the management representation letter." This confusing explanation, however, concedes that the letters McNeeley obtained were from management (a related party), and not a third party. Furthermore, these management representation letters did not expressly address the Transfers and thus did not support the legitimacy of the Transfers.[40]

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[38] AU § 334.09.

[39] AU § 334.10e.

[40] *Cf. Kevin Hall, CPA*, Exchange Act Rel. No. 61162 (Dec. 14, 2009), 97 SEC Docket 23679, 23692 (finding insufficient evidence to conclude that auditors engaged in unreasonable conduct where auditors questioned management about the problematic transactions and included a representation about the problematic transactions in the management representation letter).

3. Failure to Ensure Issuance of an Accurate Audit Report

McNeeley also failed to ensure that E&Y issued accurate audit reports. GAAS require that the financial statements subject to an audit be presented in accordance with GAAP.[41] GAAP, as compared to GAAS, focus "not upon an auditor's judgment but upon how specific accounting tasks should be performed."[42] GAAP include FAS 57, which requires that disclosure of related-party transactions must indicate (i) the nature of the relationship involved; (ii) a description of the transaction; (iii) the dollar amount of the transaction; and (iv) amounts due from or to related parties and, if not otherwise apparent, the terms and manner of settlement.[43] Here, McNeeley failed to ensure that AA Capital's and the Equity Fund's financial statements disclosed the Transfers in compliance with GAAP.

McNeeley claims that AA Capital's and the Equity Fund's financial statements complied with GAAP, but we fail to see how. The financial statements included the Transfers only vaguely as part of an "account receivable" and provided no information about the parties involved, terms, or manner of settlement. In fact, McNeeley had no real means of ensuring that the financial statements complied with FAS 57, as she saw essentially no evidential material providing the information required by FAS 57 nor did she make any other real attempt to understand the Transfers.

The Transfers also do not fall within an exception to FAS 57, which states that "[i]n some cases, aggregation of similar transactions by type of related party may be appropriate."[44] As the exception explains, "[s]ometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient."[45] That is not the case here. The Transfers were purportedly tax-related transfers to an officer. The only similar transaction

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41 *See* AU § 410.01 ("The first standard of reporting is: The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.").

42 *Dearlove v. SEC*, 573 F.3d 801, 804 (D.C. Cir. 2009). GAAP include a hierarchy of statements published by the Financial Accounting Standards Board ("FASB") and by the AICPA. The highest level of GAAP hierarchy consists of the FASB Statements of Financial Accounting Standards ("FAS"). On June 30, 2009, FASB issued the FASB Accounting Standards Codification® ("FASB ASC") and established the FASB ASC as the source of authoritative U.S. GAAP. FASB ASC is effective for interim and annual periods ending after September 15, 2009. *See* Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification, Exchange Act Rel. No. 60519A (Aug. 19, 2009), 96 SEC Docket 19829. FAS 57 is currently codified in FASB ASC Topic 850, Related Party Disclosures. Because the conduct at issue took place before the codification, this opinion uses the FAS designations.

43 FAS No. 57 ¶2.

44 FAS No. 57 n.3.

45 *Id.*

was AA Capital's transfer to Oliver. AA Capital's other related-party transactions involved reimbursable expenses to AA Capital's related funds – transactions that the financial statements fully disclosed and that did not relate to the Transfers.

C. McNeeley Acted Highly Unreasonably

Our Rule 102(e) analysis finally examines whether McNeeley's auditing failures were highly unreasonable. Highly unreasonable conduct "is an intermediate standard, higher than ordinary negligence but lower than the traditional definition of recklessness."[46] Whether conduct is highly unreasonable is measured objectively by the degree of the departure from professional standards rather than by the intent of the accountant.[47] McNeeley violated that standard here.

As noted earlier, verifying that the Partnership Agreement allowed the Transfers was perhaps the most basic auditing step McNeeley could have taken during the audit, but did not. The record establishes, however, that McNeeley either (i) never discovered the obvious inconsistencies between the Partnership Agreement and the Transfers' terms, or (ii) she discovered those inconsistencies but took no steps to reconcile them. Either conclusion constitutes an egregious auditing failure.

McNeeley also faced a variety of other red flags that she should have investigated further. Such investigation could have involved any number of simple, obvious follow-up steps, such as requiring AA Capital to produce copies of IRS correspondence or cancelled checks to validate the Transfers. Instead, McNeeley relied only on management representations, knew only what information Stevens provided to her – information that was vague and contradictory – and confirmed only how much money flowed from the Equity Fund to Orecchio.[48]

McNeeley's reliance on Stevens's unsupported representations was made worse by the fact that McNeeley had previously determined that AA Capital's internal controls were "ineffective." McNeeley downplays the significance of that determination by arguing that AA Capital's internal controls were ineffective "only in the sense that the audit team could not rely on such controls as a substitute for conducting substantive audit procedures; and . . . this was completely ordinary for a relatively small and new private equity company." This, however, is exactly the point. A determination that AA Capital had weak internal controls did not mean the company was necessarily doing anything wrong. It did, however, alert McNeeley that she should rely on more than management representations.

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[46] *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,167.

[47] *Id.*

[48] *Cf., e.g., McCurdy*, 57 S.E.C. at 295 ("McCurdy failed to undertake such simple, obvious steps as contacting [the fund investment adviser] or the [fund's] Trustees for more information, or reviewing copies of [the investment adviser]'s tax returns or credit reports. Under these circumstances, McCurdy's failure to obtain additional competent evidence regarding the collectibility of the Receivable was highly unreasonable.").

McNeeley further exacerbated the unreasonableness of her auditing conduct by denying readers of the financial statements any chance to make their own determination about the Transfers. The financial statements gave readers no way to know that AA Capital had lent $1.9 million to Orecchio or what the terms of that loan were. Even E&Y's own internal disclosure checklist, which McNeeley went through when conducting the audit, reminded its auditors of FAS 57's requirements and stated that accounts receivable from officers or employees "must be shown separately and not included under a general heading such as notes or accounts receivable." Although a firm's own internal guidance may not be a professional standard on which we can base a finding of improper professional conduct under Rule 102(e), E&Y's internal guidance was such an obvious reminder of GAAP's requirements that the guidance made McNeeley's failure to comply all the more glaring.[49]

Any one of McNeeley's auditing failures would have been highly problematic. But taken together, the failures are especially egregious. McNeeley was faced with multiple red flags surrounding a material, related-party transaction. She had any number of avenues for investigating those red flags, but pursued none of them. She then compounded those failures by not ensuring that, at a minimum, readers of the financial statements would be aware of the Transfers and could thus make their own determination about the Transfers' importance. This failure to comply with auditing standards with respect to the Transfers constituted highly unreasonable conduct as defined in Rule 102(e).

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McNeeley presents several broad, generalized, arguments about why we should not find her conduct to have been highly unreasonable. She argues, for instance, that it is inconsistent to find that she acted highly unreasonably when the law judge found that her supervisor, Oprins, had not acted highly unreasonably during the same audit. The law judge's finding regarding Oprins, however, is not before us on appeal. And while the law judge ultimately found that Oprins had not acted highly unreasonably for purposes of Rule 102(e), the law judge also found that Oprins had failed to comply with auditing standards.

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[49] *Cf. Dormu v. District of Columbia*, 795 F. Supp. 2d. 7, 29 (D.D.C. 2011) (noting that the D.C. Court of Appeals has "held that internal guidelines and policies do not establish a standard of care, but 'may properly be received in evidence as bearing on the standard of care'" (citations omitted)); *Sabratek Liquidating LLC. v. KPMG LLP*, No. 01-C-9582, 2003 WL 22715820, at *6 (N.D. Ill. 2003) (unpublished) (noting that KPMG's internal standards and procedures "could shed light on KPMG's knowledge of applicable accounting standards and whether the result of its conduct was foreseeable"); *Gregory O. Trautman*, Exchange Act Rel. No. 61167 (Dec. 15, 2009), 98 SEC Docket 26534, 26563 (finding recklessness where petitioner did not know that late trading was illegal despite internal instruction manual that mandated that orders be placed before 4:00 p.m.).

Of more significance, however, is that GAAS establish different roles and responsibilities for different audit team members. GAAS explain that "[a]uditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining."[50] Here, as engagement partner, Oprins was responsible for, among other things, overseeing the audit manager (*i.e.*, McNeeley), reviewing the workpapers, and signing the audit report. McNeeley, by comparison, was responsible for overseeing day-to-day audit planning, executing audit strategy, supervising audit staff, and reviewing audit workpapers in significant risk areas. Significantly, she was also responsible for reporting to Oprins any significant questions concerning the audit.[51] Any failure by McNeeley to bring such red flags to Oprins's attention, therefore, could explain how Oprins could have performed his duties in a manner commensurate with his knowledge, skill, or ability, even where McNeeley did not.

We recognize that Oprins was told about the loans, but the record is unclear whether McNeeley brought the red flags to his attention. Given the uncertainty in the record, we cannot say whether Oprins knew or should have known about the problems surrounding the Transfers. McNeeley, however, had the red flags in front of her. Given her role in the audit, we therefore conclude it is appropriate to find that she engaged in improper professional conduct.[52]

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[50] AU § 230.06.

[51] *Cf.* AU § 311.14 ("The auditor with final responsibility for the audit should direct assistants to bring to his attention significant accounting and auditing questions raised during the audit so that he may assess their significance.").

[52] McNeeley filed a letter with the Commission on November 9, 2011, repeating an assertion made during oral argument that the law judge erred when concluding that "the record does not establish that Oprins was ever made aware that the Transfers were purportedly made to satisfy an erroneous tax liability." McNeeley argues that the law judge's conclusion was wrong because Oprins, in his Amended and Restated Answer to the OIP, "admit[ed] that he was told that Orecchio borrowed the [$1.92 million] as a loan to pay an erroneous tax assessment." In her letter, McNeeley attached Oprins's Answer "for the Convenience of the Commissioners because it was discussed during oral argument on November 2, but was not attached to any of the briefs."

On November 16, 2011, the Division moved to strike McNeeley's letter, arguing that "the Answer was already part of the record submitted to the Commission pursuant to Commission Rule of Practice 460." The Division added that "the content of the letter shows that its true purpose is to argue again certain factual findings in the Initial Decision." We grant the Division's motion. As discussed in the text, the issue is not whether Oprins was told about the loans, but whether McNeeley alerted Oprins to the various red flags surrounding those loans. McNeeley's letter adds nothing that was not already argued or part of the record, and our Rule of Practice 450(a) provides that, "[n]o briefs in addition to those specified in the briefing schedule order may be filed except with leave of the Commission." 17 C.F.R. § 201.450(a).

McNeeley also disputes the sufficiency of the Division's evidence by pointing to the fact that a majority of witnesses at the hearing testified that her conduct was reasonable. The majority of witnesses, however, were McNeeley's own witnesses. It is not surprising that those witnesses testified in McNeeley's favor. We find, however, that the Division's expert's testimony and conclusion that McNeeley's conduct was "an extreme departure from GAAS" was more persuasive.

McNeeley challenges the persuasiveness of the Division's expert by asserting that the expert "conceded" that McNeeley did not engage in highly unreasonable conduct. We disagree with that characterization of the testimony. The expert's supposed concession occurred during cross-examination, during which the expert acknowledged that reasonable auditors could disagree with his conclusion that McNeeley's conduct was an extreme departure from GAAS, *i.e.*, that her conduct was reckless. The expert then added that it was "certainly possible" that reasonable auditors could disagree about whether McNeeley's conduct was reasonable.

Because GAAS "were established by consensus among members of the accounting profession," accounting professionals can, by GAAS's very nature, disagree about their provisions.[53] Thus, read in context, the Division's expert's statements were no more than a reflection of the process by which GAAS were established. The expert was otherwise unequivocal about his conclusion that McNeeley's conduct was an extreme departure from GAAS, and our findings that McNeeley's conduct was highly unreasonable are consistent with that testimony. Moreover, even if, as McNeeley claims, the Division's expert had conceded that McNeeley's conduct was not highly unreasonable, the Commission has its own expertise and is not bound by expert testimony regarding auditing standards. In fact, determining whether McNeeley's conduct was highly unreasonable is the reason for this proceeding. As we have explained, "while the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice."[54]

IV.

When determining an appropriate sanction, "we are mindful of the remedial nature of Rule 102(e) and our purpose in promulgating the rule to ensure that the Commission's 'processes continue to be protected, and that the investing public continues to have confidence in the

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[53] PCAOB Release 2003-025 (Dec. 17, 2003), PCAOB Rulemaking Docket Matter No. 010 (noting that "generally accepted" auditing and accounting standards were established by consensus).

[54] *Haskins & Sells*, Accounting Series Release No. 73 (Oct. 30, 1952), 1952 SEC LEXIS 1062, at *28; *see also Dearlove*, 92 SEC Docket at 1897-98 (noting that "[t]he Commission may consider expert testimony, but it is not bound by such testimony even where it is available").

integrity of the financial reporting process.'"[55] As we recognized in our release adopting the 1998 amendments to Rule 102(e), "the Commission has limited resources" and therefore "must rely on the competence and independence of the auditors who certify, and the accountants who prepare, financial statements."[56] Because of this, the Commission and the investing public must "rely heavily on accountants to assure corporate compliance with federal securities law and disclosure of accurate and reliable financial information."[57]

McNeeley failed to meet these obligations. McNeeley was responsible for auditing a material, related-party transaction that raised obvious concerns. She had ample opportunity to investigate these red flags, yet did essentially nothing. McNeeley instead deferred to her client's unsupported representations about the Transfers during the audit and to her client's subsequent, limited disclosure preferences in the financial statements. Such an egregious failure to comply with auditing standards "jeopardize[s] the achievement of the objectives of the securities laws and can inflict great damage on public investors."[58]

McNeeley's conduct also indicates a risk that she will commit future violations. As the D.C. Circuit has recognized, "the existence of a violation raises an inference that it will be repeated,"[59] and McNeeley has made clear that she intends to remain an auditor if permitted. Our concern that McNeeley will commit future violations is exacerbated by McNeeley's subsequent failure to recognize the wrongfulness of her conduct. McNeeley has consistently asserted that she conducted the audit appropriately. While a respondent has the right to present a vigorous defense, McNeeley's testimony and subsequent arguments on appeal reflect a continuing failure to grasp the role of an auditor. McNeeley argues, for example, that she had no duty to verify the legitimacy of the reasons for the Transfers (*e.g.*, verifying that Orecchio owed the taxes that he claimed). This assertion ignores the importance of obtaining third-party evidence, especially when auditing related-party transactions and, more generally, displays a failure to appreciate the overarching obligation to exercise due care and professional skepticism. McNeeley also testified, and now argues on appeal, that the evidential matter she obtained from AA Capital was sufficient to understand the Transfers. That evidential matter, however, consisted almost exclusively of management representations that were often vague and contradictory. Perhaps most troubling, McNeeley not only fails to recognize her failures, but she also argues that "[t]his case arose only because a criminal audit client, who now resides in a federal prison, successfully led an effort to defraud her and the rest of the audit team." Orecchio's fraud, however, did not cause her auditing

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[55] *Dearlove*, 92 SEC Docket at 1912 (quoting *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,164).

[56] *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,165.

[57] *Id.*

[58] *Touche Ross & Co.*, 609 F.2d at 581.

[59] *Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004) (affirming violation of Securities Act Section 5 and related cease-and-desist order).

failures. Her highly unreasonable conduct caused her auditing failures. Orecchio's fraud served only to expose those failures. Such an inability to recognize the wrongfulness of her conduct gives us concern that McNeeley will repeat her misconduct in the future.

McNeeley disputes that a likelihood of her committing a future violation exists because of her "perfect record in the nearly six years since the [a]udits." An otherwise clean disciplinary history, however, is not determinative for purposes of our sanctions analysis.[60] We also find little assurance in McNeeley's performance history given that McNeeley would have known that, once the Commission instituted these proceedings, her conduct would be more highly scrutinized, which reduced the likelihood of her committing additional misconduct during this time.

We recognize that imposing a sanction on McNeeley could have collateral consequences, such as tarnishing her reputation, but such consequences are outweighed by our concern that "[a]n incompetent or unethical practitioner has the ability to inflict substantial damage to the Commission's processes, and thus the investing public, and to the level of trust and confidence in our capital markets."[61] We have accordingly warned that "'where such individuals engage in professional misconduct which impairs the integrity of the Commission's processes, the Commission has an obligation to respond through the application of' Rule 102(e)."[62]

On appeal, McNeeley argues that any suspension at this stage of the proceedings would be punitive because the Division did not issue the OIP until "nearly five years after the Audits ended." McNeeley claims that, "[i]f there were a legitimate need to protect the public, Ms. McNeeley would not have been allowed to continue practicing before the Commission year after year after year." We disagree. Bringing a 102(e) case against an accountant involves various complexities, not the least of which is that problems with an audit, which can be complex, are not typically brought to light until the problems with the underlying financial statements are understood. The Commission is also entitled to prioritize its resources toward disciplining fraudsters. Although auditors and the underlying fraudsters both pose a threat to the public, they present the Commission with differing priorities, which are reflected in the different sanctions

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[60] *Cf., e.g.*, *Steven Altman, Esq.*, Exchange Act Rel. No. 63306 (Nov. 10, 2010), 99 SEC Docket 34405, 34437 n.81 (imposing bar against attorney for engaging in improper profession conduct under Rule 102(e) despite attorney's previously clean disciplinary record), *petition denied*, 666 F.3d 1322 (D.C. Cir. 2011); *James C. Dawson*, Advisers Act Rel. No. 3057 (July 23, 2010), 98 SEC Docket 30697, 30704 (imposing bar despite respondent's previously clean record in a nearly thirty-year career and respondent's claim that such a record established a "marked unlikelihood" of future violations); *Gary M. Kornman*, Exchange Act Rel. No. 59403 (Feb. 13, 2009), 95 SEC Docket 14246, 14259 (imposing bar despite respondent's lack of disciplinary history), *petition denied*, 55 F.3d 173 (D.C. Cir. 2010).

[61] *Altman*, 99 SEC Docket at 34437 (quoting *Keating, Muething, & Klekamp*, 47 S.E.C. 95, 120 (1979) (concurring opinion)) (imposing bar while noting the "potential collateral consequences that may result from our decision in this case").

[62] *Id.* (quoting *Keating*, 47 S.E.C. at 120).

ultimately leveled against the various actors involved with fraudulent financial statements (*e.g.*, jail for Orecchio; a professional bar for Stevens; and a six-month suspension for McNeeley). Our rules, in fact, reflect these differing priorities by expressly contemplating that government resources will be focused first toward the fraudsters. Rule 210(c)(3), in particular, allows criminal prosecutorial authorities, such as the U.S. Department of Justice, to seek a stay of a Commission enforcement or disciplinary hearing "during the pendency of a criminal investigation or prosecution arising out of the same or similar facts that are at issue"[63] – a rule the Department of Justice has used in the past to stay Commission Rule 102(e) proceedings against auditors.[64]

Here, the delay in instituting the proceedings obviated the need for a stay by the Department of Justice, and the OIP was issued less than a month after Orecchio pleaded guilty in his criminal proceedings and within three and one half years of the Division discovering the fraud. This timing is consistent both with the considerations described above and with other administrative proceedings in which we have imposed sanctions against auditors under Rule 102(e).[65] We therefore see nothing unusual or punitive about imposing a sanction at this stage of the proceedings.

McNeeley challenges the appropriateness of imposing a suspension by arguing that the record contains no evidence that her misconduct was intentional.[66] We have explained, however, that "a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive."[67] A disciplinary matter involving highly unreasonable conduct is

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[63] 17 C.F.R. § 201.210(c)(3).

[64] *See Hall*, 97 SEC Docket at 23689 (noting that "[l]argely because the administrative proceeding was stayed at the request of the Department of Justice, pending resolution of criminal proceedings arising out of the fraud, the hearing did not begin until July 2007," which was approximately seventeen months after the order instituting proceedings was filed).

[65] *See, e.g.*, *Marrie*, 374 F.3d at 1199 (involving OIP that was issued "just shy of five years" after audit at issue); *Dearlove*, 92 SEC Docket at 1873, 1919 (involving OIP that was issued more than four years after audit at issue).

[66] McNeeley also argues that the law judge erred by failing to conduct the multi-factor public interest analysis outlined in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The D.C. Circuit, however, has recognized that "the Commission is not required to follow any mechanistic formula in determining an appropriate sanction." *Kornman v. SEC*, 592 F.3d 173, 186 (D.C. Cir. 2010).

[67] *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,167.

therefore not necessarily less egregious than one involving intentional or reckless conduct, and, for all the reasons described in this opinion, we believe that this is such a case.[68]

Nevertheless, we believe that certain factors weigh in favor of a more measured sanction than the three-year suspension that the Division believes is appropriate. McNeeley, for example, was a relatively young auditor at the time of the audits and had not been in the industry as long as some others against whom we have imposed sanctions under Rule 102(e).[69] McNeeley was also overseen by a supervisor, Oprins, who the law judge found had not fully complied with his own auditing duties. Although the law judge ultimately concluded that Oprins's auditing failures did not amount to highly unreasonable conduct under Rule 102(e), Oprins's conduct during the audit raised sufficient questions about the adequacy of Oprins's supervision to suggest that a sanction less severe than what the Division requests is appropriate.

In weighing all of the considerations, we therefore believe that a six-month suspension from appearing or practicing before the Commission is appropriate. This time spent out of auditing will impress upon McNeeley the severity of her auditing failures, thus providing specific deterrence to her and providing more general deterrence to the auditing profession.

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[68] *See Dearlove*, 92 SEC Docket at 1912 (recognizing "that, under some circumstances, unreasonable conduct is not necessarily a less egregious disciplinary matter than either intentional or reckless conduct, or highly unreasonable conduct in circumstances warranting heightened scrutiny").

[69] *See, e.g., Dearlove*, 92 SEC Docket at 1913 (imposing four-year suspension for auditor who had been an accountant for approximately twenty-five years at time of audit by noting, in part, that "Dearlove's lengthy audit experience makes his failure to conduct the . . . audit in accordance with applicable professional standards all the more troubling"); *McCurdy*, 57 S.E.C. at 295-96 (imposing one-year suspension for auditor who had been a CPA for nearly twenty years at time of audit by noting, in part, that "[t]his lengthy experience makes his failure to conduct the audit in accordance with applicable professional standards particularly troublesome").

For the reasons above, we find that McNeeley engaged in improper professional conduct as defined in the Commission's Rule of Practice 102(e) and that, as a result, McNeeley should be denied the privilege of appearing or practicing as an accountant before the Commission for six months. An appropriate order will issue.[70]

By the Commission (Chairman SCHAPIRO and Commissioner WALTER); Commissioner PAREDES, concurring in part and dissenting only with respect to the sanction imposed, Commissioners AGUILAR and GALLAGHER not participating.

Elizabeth M. Murphy
Secretary

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

Commissioner PAREDES, dissenting with respect to the sanction imposed:

The Commission has found that Wendy McNeeley, a certified public accountant and audit manager, violated the Commission's Rule of Practice 102(e) ("Rule 102(e)"). Although I concur, on the basis of the record before us, that McNeeley's conduct violated Rule 102(e), I cannot support the sanction imposed by the majority of the Commission. In light of the facts of this matter, a six-month suspension from appearing or practicing before the Commission is more severe than is appropriate to achieve its purpose.[1]

The conduct of McNeeley that gave rise to this matter occurred over seven years ago while McNeeley served as audit manager for an audit of a client's 2004 financial statements. Over the course of the past several years, McNeeley has had ample time to reflect on her failure to perform an audit according to applicable standards – an audit that, as the Commission's opinion notes, occurred when McNeeley "was a relatively young auditor."[2]

Furthermore, after the deficient audit and throughout the course of the Commission's action against McNeeley, McNeeley has been employed by a national accounting firm and has continued to appear and practice before the Commission.[3] That McNeeley has continued practicing without any other disciplinary action being brought against her indicates her comportment with professional standards of conduct and, perhaps more tellingly, belies the majority's concern that she poses such a risk that a six-month suspension is warranted at this point in her career after so much time has elapsed since the conduct underlying her Rule 102(e) violation. Simply put, the majority of the Commission too readily concludes that there is a risk that McNeeley will commit future violations.[4]

There is no evidence in the record that McNeeley has engaged in any subsequent improper professional conduct since the occurrence of the conduct that is the basis of this matter. To the contrary, McNeeley has shown over a meaningful number of years – after the violation – that she is capable of performing her responsibilities in accordance with applicable standards.[5]

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[1] *See* Commission Opinion, text accompanying *supra* note 55.

[2] Commission Opinion, text accompanying *supra* note 69.

[3] *Wendy McNeeley, CPA*, Initial Decision Rel. No. 411 (Dec. 28, 2010), 100 SEC Docket 36461, 36464-65.

[4] *See* Commission Opinion, *supra* pp. 24-25.

[5] The OIP against McNeeley was filed nearly five years after completion of the audit of the 2004 financials, and the Commission heard oral argument more than one and a half years later. No stay of proceedings against McNeeley was requested by the Department of

(continued...)

To the extent that McNeeley's clean record since the Rule 102(e) violative conduct is a result of her taking extra care, that is precisely the intended effect of a remedial sanction.

I am not persuaded that there is a justifiable remedial purpose to be served by subjecting McNeeley to a six-month suspension at this time. Therefore, I am troubled that the six-month suspension will have an unnecessarily punitive effect. The Commission's interests would be appropriately served with a less severe sanction, perhaps a censure. Accordingly, I dissent with respect to the sanction imposed by the majority of the Commission.

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[5] (...continued)
Justice, and there is nothing in the record to indicate that the length of time that passed was the result of any obstruction, cover-up, or delaying tactics on McNeeley's part.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 68431 / December 13, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3427 / December 13, 2012

Admin. Proc. File No. 3-13797

In the Matter of the Application of

WENDY MCNEELEY, CPA
c/o Robert L. Michels, Esq.
Winston & Strawn LLP
35 Wacker Dr.
Chicago, IL 60601

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that Wendy McNeeley be, and hereby is, denied the privilege of appearing or practicing before the Commission as an accountant for six months from the date of this order.

By the Commission.

Elizabeth M. Murphy
Secretary