

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 69930 / July 3, 2013

Admin. Proc. File No. 3-14795

In the Matter of the Application of

S.W. HATFIELD, C.P.A.  
and  
SCOTT W. HATFIELD, C.P.A.  
c/o John A. Koepke  
Jackson Walker L.L.P.  
901 Main St., Ste. 6000  
Dallas, TX 75202

For Review of Disciplinary Action Taken by

PCAOB

OPINION OF THE COMMISSION

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD -- REVIEW OF  
DISCIPLINARY PROCEEDINGS

**Violation of Board Rules**

**Improper Professional Conduct**

Registered public accounting firm and associated person engaged in improper professional conduct in the audit of the financial statements of two public companies. *Held*, findings of violations and sanction imposed are *sustained*.

APPEARANCES:

*John A. Koepke*, of Jackson Walker, L.L.P, for S.W. Hatfield, CPA, and Scott W. Hatfield, CPA.

*J. Gordon Seymour* and *Davis B. Tyner* for the PCAOB.

Appeal filed: March 8, 2012  
Last brief received: June 13, 2012

**I.**

S.W. Hatfield, a registered public accounting firm (the "Firm"), and Scott W. Hatfield, C.P.A., the Firm's sole owner and employee (collectively, "Applicants"), filed an application pursuant to § 107(c) of the Sarbanes-Oxley Act of 2002<sup>1</sup> for review of disciplinary action taken by the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). Acting pursuant to § 105(c)(4) of Sarbanes-Oxley<sup>2</sup> and PCAOB Rule 5300(a),<sup>3</sup> the Board found that Applicants violated PCAOB Rules 3100<sup>4</sup> and 3200T<sup>5</sup> by failing to adhere to professional standards during their audits of financial statements of two unrelated public companies. The Board further found that Applicants' conduct was at least reckless and that it was therefore in the public interest to permanently revoke the Firm's registration and permanently bar Hatfield from association with a registered public accounting firm. We base our findings on an independent review of the record.

**II.**

Pursuant to § 107(c)(2) of Sarbanes-Oxley, we will sustain the Board's conclusion that Applicants violated PCAOB rules if the record shows that Applicants engaged in the alleged violative conduct, that such conduct violated PCAOB rules, and that the PCAOB applied those rules in a manner consistent with the purposes of the Securities Exchange Act of 1934 and Sarbanes-Oxley.<sup>6</sup> In performing this analysis, we conduct a *de novo* review, pursuant to which

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<sup>1</sup> 15 U.S.C. § 7217(c).

<sup>2</sup> *Id.* § 7215(c)(4). Section 105(c)(4) of Sarbanes-Oxley authorizes the Board to impose sanctions, including revocation of the registration of a public accounting firm and a bar from association of an associated person, if a registered firm or an associated person violates PCAOB rules or professional standards.

<sup>3</sup> Rule 5300(a) provides that the Board may impose "such disciplinary or remedial sanctions as it determines appropriate," including "permanent revocation of registration" and "permanent suspension or bar of a person from further association with any registered public accounting firm." PCAOB rules may be found at the Board's website: <http://pcaobus.org>.

<sup>4</sup> PCAOB Rule 3100 requires registered public accounting firms and their associated persons to comply with the Board's "auditing and related professional practice standards" in connection with the preparation or issuance of any audit report for an issuer, as defined in Sarbanes-Oxley. Rule 1001(a)(viii) defines the term "auditing and related professional practice standards" to mean "the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of Sarbanes-Oxley), and any other professional standards, that are established or adopted by the Board under Section 103 of the [Sarbanes-Oxley] Act."

<sup>5</sup> In April 2003, the Board adopted certain preexisting standards as its interim standards. PCAOB Rule 3200T states that, "[i]n connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002)), to the extent not superseded or amended by the Board." The interim standards are hereinafter cited as "AU §\_\_."

<sup>6</sup> 15 U.S.C. § 7217(c)(2) (stating that the provisions of Exchange Act §§ 19(d)(2) and 19(e)(1), 15 U.S.C. §§ 78s(d)(2) and (e)(1), "shall govern the review by the Commission of final disciplinary sanctions imposed by the Board . . . as fully as if the Board were a self-regulatory organization and the Commission were the appropriate regulatory agency for such organization for purposes of those sections 19(d)(2) and 19(e)(1)").

we apply a preponderance of the evidence standard to determine whether the record supports the PCAOB's findings that Applicants' conduct violated its rules.<sup>7</sup> We find here that the record supports the PCAOB's findings that Applicants violated PCAOB Rules 3100 and 3200T by repeatedly failing to adhere to the Board's interim auditing standards during audits of two unrelated public companies: Bidville, Inc., and Epicus Communications Group, Inc.

As we explain below, Applicants failed to adhere to a variety of interim auditing standards, but Applicants' overarching failing was not exercising the necessary professional skepticism required to obtain sufficient audit evidence on which to base their audit opinion. Applicants consistently lacked the professional skepticism essential to evaluate the reliability and pertinence of the evidence on which they based their auditing opinions,<sup>8</sup> and it was this core deficiency that ultimately led to Applicants' more specific auditing violations.<sup>9</sup> Applicants failed to meet this requirement in the audits at issue multiple times and in multiple ways, but two defects permeated their problematic auditing approach. First, Applicants frequently relied on generalized experience from their past history with other clients to draw conclusions about the Bidville and Epicus financial statements without any reasoned basis for concluding that such experience was applicable to Bidville or Epicus. Second, Applicants repeatedly deferred to untested management representations—in the face of red flags that should have raised questions about the reliability of those representations—as an excuse not to undertake meaningful audit procedures. Although management representations are part of the evidential matter auditors may obtain during an audit, the interim auditing standards explain that they "are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."<sup>10</sup> Instead, representations are a complement to other auditing procedures, and "[b]ased on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified."<sup>11</sup>

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<sup>7</sup> Cf. *Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of evidence standard in NASD disciplinary proceeding); *Richard G. Cody*, Exchange Act Release No. 6456, 2011 WL 2098202, at \*9 (May 27, 2011) (applying preponderance of evidence standard in FINRA disciplinary proceeding).

<sup>8</sup> See, e.g., AU § 326.02, *Evidential Matter* ("The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.").

<sup>9</sup> This appeal concerns only Applicants' failures to comply with auditing standards. Therefore, unless otherwise stated, this opinion does not make any determination with respect to whether Applicants' recommendations or Bidville's or Epicus's financial statements complied with generally accepted accounting principles ("GAAP").

<sup>10</sup> AU § 333.02, *Reliance on Management Representations*.

<sup>11</sup> AU § 333.04, *Reliance on Management Representations*.

## A. The Bidville Audit

Bidville, a Nevada corporation based in Florida, first engaged Applicants to audit the company's 2003 financial statements, which covered the period from March 1, 2003 through December 31, 2003.<sup>12</sup> At the time, Bidville's stock was quoted on the OTC Bulletin Board and its business plan was to operate an internet online auction site as a competitor to eBay.<sup>13</sup> Applicants, however, had concerns about Bidville. As Hatfield testified during the PCAOB's investigation, he believed the company was "an eBay wannabe"<sup>14</sup> and had been created as a "great stock spoof,"<sup>15</sup> and "had a high probability of being a market play."<sup>16</sup> Applicants' audit work papers similarly described Bidville as a "stock scam w/ no intent to run [a company]."<sup>17</sup> Despite these concerns about Bidville's trustworthiness, Applicants' audit opinion was based in substantial part on their generalized experience with other clients and on Bidville management's representations, but Applicants did not undertake any procedures to test the reasonableness of their reliance on that audit evidence.

### 1. Applicants audit Bidville's private placement agreement.

#### (a) Background

The first issue involves Applicants' approach during their 2003 audit to a December 2003 private placement in which Bidville sold 4,410,000 shares of restricted, unregistered common stock at \$0.50 per share. With each share that Bidville sold in the transaction, Bidville included an unregistered warrant to purchase another one-half share of Bidville restricted, unregistered common stock at a price of \$1.00 per share. Applicants recommended that Bidville report the transaction as a "compensation expense related to common stock issuance at less than 'fair value.'"<sup>18</sup> Applicants further recommended that Bidville calculate the compensation expense by applying a fifty percent "haircut" to the stock's closing price on the date of the transaction and then, from that number, subtracting the \$0.50 per share selling price.<sup>19</sup> Applicants also

<sup>12</sup> Applicants' audit report covered the transition period from March 1, 2003, through December 31, 2003, because Bidville changed its fiscal year-end from February 28 to December 31 in connection with a December 2003 reverse merger in which Bidville acquired NoBidding, Inc., a New Jersey corporation.

<sup>13</sup> On November 8, 2011, the Commission revoked the registration of Bidville's registered securities pursuant to Section 12(j) of the Exchange Act because of the company's failure to file a periodic report since it filed a Form 10-QSB for the period ended September 30, 2005, in which Bidville reported a net loss of more than \$2 million for the previous nine months. Order Making Findings and Revoking Registrations by Default as to Six Respondents, Exchange Act Release No. 65701, 2011 WL 5357822, at \*2, \*4 (Nov. 8, 2011).

<sup>14</sup> Division Exhibit ("DX") 3 at 35.

<sup>15</sup> *Id.* at 36.

<sup>16</sup> Transcript of Hearing ("Tr.") at 97.

<sup>17</sup> DX-15 at 217.

<sup>18</sup> DX-7 at 109.

<sup>19</sup> Hatfield testified that he believed the stock's closing price reflected the true value of the stock because, "It's been my perspective that if the market sets the value, then that's a valid value to use." Tr. at 104. At the same time, however, Hatfield acknowledged that the Bidville stock had no "market support." *Id.*

recommended that Bidville assign no value to the warrants. Using this methodology, Applicants recommended that the company state the value of the stock Bidville sold in its private placement as approximately \$10 million less than the stock's trading value.

Hatfield acknowledged during his investigatory testimony that he did not ask, or even consider, whether Bidville's private placement was actually a compensation-related expense. He testified that he did not know or investigate whether any services were provided by the shareholders with regard to the transaction, nor did he know or consider whether the shareholders had any particular relationship to the company. And when asked whether he thought the transaction was a compensation-related expense, Hatfield responded, "no, ma'am, it's not. Never has been. It's not related to services."<sup>20</sup> Hatfield explained that Applicants nevertheless made that recommendation because of what Hatfield described as "directions from the Securities and Exchange Commission staff" during audits of previous clients.<sup>21</sup> Hatfield admitted, however, that he did not discuss the Bidville transaction with Commission staff, nor was he aware of anything in writing from the Commission that directly supported his methodology other than Commission comment letters issued during the review of registration statements filed by other entities in which the Commission had not taken issue with those entities' disclosures of compensation-related expenses. Hatfield also testified that he did not know whether GAAP supported either the need for a compensation expense adjustment or the application of a fifty-percent discount. As Hatfield explained, "[w]hile there may or may not be GAAP on this point specifically, the review comments received on other similar transactions have taught me that this is the appropriate methodology."<sup>22</sup>

At Applicants' disciplinary hearing, Hatfield further explained that they made their recommendation based on their understanding of "unwritten industry accepted position . . . that the acceptable discount was 50 percent."<sup>23</sup> Hatfield testified that he first reached this understanding based on discussions with "a client who had significant securities experience" and that this understanding "was later supported by the SEC through not issuing any comments [about this practice] during reviews of registration statements."<sup>24</sup> Hatfield also introduced a list of nineteen other auditing clients that he claimed had applied a similar reduction in value to their stock sales and claimed that the Commission had never issued a negative comment regarding those companies' approaches.

As for Applicants' recommendation not to assign any value to the warrants, Hatfield acknowledged during his investigative testimony that it may have been inconsistent for him to recommend ascribing a value for the underlying stock but not for the warrants to buy stock: "Sitting here discussing it now, yes, sir, and I may have missed one."<sup>25</sup> But Hatfield later

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<sup>20</sup> DX-3 at 110.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 108.

<sup>23</sup> Tr. at 126.

<sup>24</sup> *Id.*

<sup>25</sup> DX-3 at 116.

testified at the hearing that he had "revisited the situation"<sup>26</sup> and now believed, based on "my personal experience with comparable situations,"<sup>27</sup> that Applicants were correct in assigning no value to the warrants. Hatfield acknowledged, however, that his analysis regarding the warrants was something he had done after responding to PCAOB staff. Hatfield nevertheless reasoned that, "I believe, while I have two different methodologies then and now, the answer is the same [*i.e.*, that the warrants had no value]."<sup>28</sup>

Bidville accepted Applicants' recommendations and listed the private placement as a compensation expense in its 2003 financial statements filed with the Commission in Bidville's Form 10-KSB on April 2, 2004. Accompanying Bidville's financial statements was Applicants' audit report, in which Applicants opined that Bidville's financial statements were fairly stated, in all material respects, in conformity with GAAP.

**(b) Analysis**

The PCAOB found that Applicants failed to meet the interim auditing standards' requirements that Applicants (i) exercise due care during their audit and in preparing their audit report<sup>29</sup> and (ii) obtain evidence sufficient to afford a reasonable basis for their audit opinion with respect to the financial statements under audit.<sup>30</sup> We agree with these findings.

To exercise due care, auditors must maintain an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence."<sup>31</sup> Applicants failed to fulfill this duty when determining whether Bidville had correctly valued and disclosed the private placement in the company's 2003 financial statements. Applicants blindly relied on their past experience instead of making any meaningful attempt to understand the facts relevant to the private placement. Other than checking Bidville's closing stock price, Applicants relied only on what another client told them was an "unwritten industry accepted position"<sup>32</sup> and on a methodology Applicants claim nineteen other clients had used when valuing their own stock sales.<sup>33</sup> This was not enough.

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<sup>26</sup> Tr. at 108.

<sup>27</sup> *Id.* at 109.

<sup>28</sup> *Id.*

<sup>29</sup> AU § 150.02, *Auditing Standards* ("Due professional care is to be exercised in the performance of the audit and the preparation of the report."), § 230.01, *Due Professional Care in the Performance of Work* (same).

<sup>30</sup> AU § 150.02 ("Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."), § 326.01, *Evidential Matter* (same).

<sup>31</sup> AU § 230.07, *Professional Skepticism*; see also AU § 230.08, *Professional Skepticism* ("Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process.").

<sup>32</sup> Tr. at 126.

<sup>33</sup> In their briefs, Applicants also cite to testimony by the concurring reviewer on the Bidville audit, Stephen Durland, who testified at a deposition during the PCAOB's investigation in this case that he also believed that use of a fifty-percent discount had "been accepted practice by the [C]ommission staff for a number of years." DX-39 at 106.

Although a reasonable place to begin one's audit, Applicants' evidence concerning other companies' experiences told Applicants little about whether *Bidville* appropriately presented its private placement as a compensation expense or whether *Bidville* appropriately applied a fifty-percent discount when calculating that expense. To the contrary, Hatfield did not actually believe *Bidville*'s private placement should have been classified as a compensation expense. This contradiction alone should have alerted Applicants that the other companies' approaches might not have been applicable to *Bidville*. But Applicants undertook no further analysis of whether these other companies' valuation approaches were appropriate for *Bidville*.

Applicants' small sample size of other companies' supposed audit approaches also fell well short of establishing what Applicants claim was a uniform, industry-wide practice.<sup>34</sup> At most, all Applicants knew was what a select group of companies did in a few isolated instances, not what all companies did uniformly as an across-the-board policy. Moreover, the supposed silence or inaction of Commission staff in its reviews of these other companies' registration statements may not be construed as Commission approval of those companies' practices, let alone be construed as approval of Applicants' approach to valuing *Bidville*'s stock transactions.<sup>35</sup> Even Applicants' own expert conceded in his report that "[i]n 2003, there was no clear guidance from the SEC, FASB, or PCAOB except for the 'up to 50% discount' which was the limit to what was generally allowable"<sup>36</sup> and that using a fifty percent discount was not a "hard, fast rule."<sup>37</sup> Applicants acknowledge "there is no specific comment letter from the SEC staff that approves the use of a 50% 'haircut' on a stock's closing price for valuation purposes."<sup>38</sup> In short,

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Durland could not recall, however, any specifics about how he reached that conclusion other than to refer generally to "[y]ears of dealing with the SEC where I have run into the same issue in the past." *Id.* at 100.

<sup>34</sup> *Cf. Midas Sec., LLC*, Securities Act Release No. 66200, 2012 WL 169138, at \*11 (Jan. 20, 2012) (finding that fact witness testimony about certain practices in the brokerage industry was "evidence only that the practice was widespread at these particular firms, not industry-wide").

<sup>35</sup> *Cf., e.g.*, 15 U.S.C. § 78z ("No action or failure to act by the Commission . . . shall be construed to mean that the particular authority has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein, nor shall such action or failure to act with regard to any statement or report filed with or examined by such authority pursuant to this title or rules and regulations thereunder, be deemed a finding by such authority that such statement or report is true and accurate on its face or that it is not false or misleading."); *Capital Funds, Inc. v. SEC*, 348 F.2d 582, 588 (8th Cir. 1965) (rejecting defendants' argument that the Commission should be estopped from alleging a scheme to sell unregistered securities because, defendants claimed, "the Commission investigated the . . . situation at that time but took no action").

<sup>36</sup> Respondents' Exhibit ("RX") 62 at 30.

<sup>37</sup> Tr. at 359.

<sup>38</sup> Appellants' Br. in Supp. of Pet. for Review at 19. On April 30, 2012, Applicants filed a motion pursuant to our Rule of Practice 452 seeking to introduce the following evidence: (i) a Financial Reporting Manual by the Division of Corporation Finance; (ii) a printout of a portion of the American Institute of Certified Public Accountants' website titled "Accounting for Certain Equity Transactions;" (iii) a comment letter, dated July 11, 2006, from the

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Applicants had no valid basis for believing their practice with respect to these other nineteen companies was appropriate for Bidville. Moreover, even if there had been some basis for assuming that the approach taken in those other matters was generally applicable to compensation-related expenses, Applicants conceded that they did not believe that Bidville's private stock placement actually was a compensation-related expense. And Applicants have identified no basis for failing to assign a value to the warrants.

Applicants' approach showed an astonishing lack of professional skepticism and failure to exercise due care. Their reliance on supposed past experience also resulted in Applicants not obtaining sufficient audit evidence. As we have explained, "if an auditor fails to exercise due professional care, he may not obtain sufficient competent evidential matter to support an audit conclusion that the financial statements were prepared in compliance with GAAP."<sup>39</sup> This is exactly what occurred here. At best, Applicants knew only what some other companies had allegedly done in different situations. Applicants had no evidence about how those approaches were applicable to Bidville, and they sought no other evidence that would help them analyze

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Division of Corporation Finance to the president of Signet International Holdings, Inc. regarding Signet's Form SB-2 filed June 2, 2006, which included Applicants' audit report; (iv) a copy of a publication by the law firm Drinker Biddle, dated June 30, 1998, titled "Understanding and Avoiding the Cheap Stock Problem;" and (v) an undated document, written by an unknown author, that purports to summarize, among other things, the Commission's and various companies' treatment of "cheap stock" and "operating expenses." Rule 452 allows us to accept additional evidence if the evidence is material and there were reasonable grounds for failure to adduce such evidence previously. 17 C.F.R. § 201.452.

Applicants state that the evidence they seek to introduce is material because it demonstrates that they had consistently treated and valued the results of private placements and compensation expense discounts "in conformity with the tacit approval given by the Commission to such treatment." Reply Brief [in Support of Applicants' Motion to Submit Additional Evidence] at 1. Applicants claim they did not attempt to introduce this evidence earlier because its relevance only became apparent after the Board issued its Final Decision.

Applicants have not established grounds for their failure to adduce such evidence previously. Applicants should have been well aware that the valuation of Bidville's private placement was relevant to Applicants' audits when the Board alleged in its OIP that Applicants "failed to perform sufficient audit procedures to determine whether the company had valued and presented the [private placement] transaction appropriately." Order Instituting Disciplinary Proceedings at 8. As an exercise of discretion, we nevertheless take official notice pursuant to Rule of Practice 323, 17 C.F.R. § 201.323, of AICPA's website and the Division of Corporation Finance's reporting manual and comment letter, which are publicly available, and admit the remaining evidence that Applicants seek to admit pursuant to Rule 452.

However, none of that evidence affects the outcome here. The Board does not challenge whether Applicants' approach during the Bidville audit was consistent with their approach during audits of other companies. Instead, the issue is whether Applicants took appropriate steps to determine whether such an approach was appropriate for Bidville, and none of that evidence answers that question, in part for the reasons discussed in *supra* note 34 and the accompanying text.

<sup>39</sup> *James Thomas McCurdy, CPA*, Exchange Act Release No. 49182, 57 SEC 277, 2004 WL 210606, at \*4 (Oct. 29, 2003) (noting the relationship between the duty to exercise due professional care and the duty to obtain sufficient evidence).



whether Bidville accurately disclosed its private placement as a compensation expense or accurately calculated that expense by applying a fifty-percent discount.

## **2. Applicants audit Bidville's consulting agreement.**

### **(a) Background**

The next area at issue concerned a December 2003 consulting agreement among Bidville, National Securities Corporation, and the Royal Palm Capital Group and the agreement's impact on Bidville's 2003 and first quarter of 2004 financial statements.<sup>40</sup> Under the agreement, National Securities was to provide consulting advice to Bidville; Royal Palm was to transfer 3,966,700 shares of Bidville stock to National Securities; and Royal Palm was to receive \$500 from National Securities.

#### **(i) Bidville's 2003 Financial Statements**

Hatfield testified that, during their 2003 audit, Applicants had asked Bidville to provide copies of all consulting contracts involving the company, but that the company had "withheld"<sup>41</sup> the National Securities and the Royal Palm consulting agreement from Applicants until April 22, 2004, several weeks after Bidville's April 2, 2004 filing of its 2003 financial statements in its Form 10-KSB. After Applicants became aware of the agreement, Bidville's vice president of finance emailed Applicants that the company intended to file an amended Form 10-KSB, which would impact its 2003 financial statements. After reviewing an initial draft of the proposed amended filing, Hatfield emailed Bidville's president on April 29, 2004 about concerns he had with Bidville's disclosures. Hatfield wrote that he believed Bidville had "[n]o one that knows how to characterize and disclose the myriad of deals and contracts being entered into."<sup>42</sup> He added that "I feel like I'm all alone on this project and I will resign in about 30 seconds if something doesn't change."<sup>43</sup> On May 3, 2004, Hatfield again emailed Bidville's president that Applicants were "concerned" with Bidville's "disclosures related to the various contracts, etc. which were not reflected in the footnotes" and with "other new disclosures which were not disclosed to us during the performance of our fieldwork on the audit of your financial statement."<sup>44</sup> Hatfield also wrote that "this behavior pattern and lack of internal control is completely and totally unacceptable" and that Applicants were evaluating whether they would continue to serve as Bidville's auditors.<sup>45</sup>

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<sup>40</sup> National Securities conducted the above-mentioned private placement on Bidville's behalf. Royal Palm was a Florida company controlled by Bidville's president and chairman, Gerald C. Parker, and was a major shareholder of Bidville.

<sup>41</sup> Tr. at 111.

<sup>42</sup> RX-18.

<sup>43</sup> *Id.*

<sup>44</sup> RX-19.

<sup>45</sup> *Id.*

Bidville nevertheless filed its amended Form 10-KSB with the Commission on May 7, 2004. In that filing, Bidville disclosed the consulting agreement, but did not adjust its previously filed 2003 financial statements. The amended Form 10-KSB also included Applicants' unqualified audit report, dated May 5, 2004, which stated that Bidville's previously filed financial statements were fairly presented in conformity with GAAP, in all material respects, and that the consulting agreement "had no effect" on those financial statements.<sup>46</sup>

Hatfield testified that Applicants reached this auditing conclusion based on Bidville's representation that the contract had not been triggered because Bidville's shares had not yet been transferred to National Securities. Hatfield testified that the only step Applicants took to determine whether management's representation about the shares was correct was to look at a single Bidville shareholder list, which Applicants "receive[d] somewhere in the course of time" and from which Applicants "could not ascertain [whether] the shares had been issued to National Securities."<sup>47</sup>

#### (ii) Bidville's First Quarter 2004 Financial Statements

On May 21, 2004, Applicants issued a review report in connection with Bidville's plan to file a Form 10-QSB on May 24, 2004 (for the quarter ending March 31, 2004). In that report, Applicants stated that they were "not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles."<sup>48</sup> On May 24, 2004, however, Applicants learned from Bidville that Royal Palm had transferred its shares of Bidville stock to National Securities in February 2004. As a result, Hatfield emailed Bidville's president about how to reflect the consulting agreement in Bidville's yet-to-be filed Form 10-QSB, but added that "[t]o make this change would totally blow the timeline to file today."<sup>49</sup> Hatfield explained in the email that Gerald Parker, Bidville's president and chairman, had therefore "agreed to let the filing go and we'll book the effect of this off-balance sheet transaction in the next quarter."<sup>50</sup>

Bidville filed its Form 10-QSB a day later, on May 25, 2004. The filing did not disclose the financial impact of the consulting agreement. At Applicants' disciplinary hearing, Hatfield testified that Applicants did not object to Bidville's filing because, Hatfield claimed, Bidville's management had told Applicants that the company would file an amended Form 10-QSB with corrected financial statements within five days of the initial filing. The PCAOB hearing officer, however, did not find Hatfield's testimony credible, noting that "no such management

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<sup>46</sup> DX-9 at 110.

<sup>47</sup> Tr. at 113-14. The record is not clear about when, if, or to what extent National Securities provided consulting services to Bidville as contemplated in the agreement.

<sup>48</sup> DX-17 at 14.

<sup>49</sup> DX-16 at 116.

<sup>50</sup> *Id.*

representation is mentioned in Hatfield's contemporaneous emails or [Applicant]s' resignation letter."<sup>51</sup>

Bidville did not amend its Form 10-QSB within the promised five days. Instead, approximately a month after Bidville filed its misstated Form 10-QSB, Hatfield emailed Bidville's president, reminding him that "the 3/31/04 10-QSB should be amended as [the National Securities] transaction took place in 2/04 and was not recorded in the Bidville financial statements."<sup>52</sup> An outside accountant that Bidville had hired, Gary Alexander, responded to Hatfield a couple of days later, writing that Alexander was "actively working on this matter" and "that a satisfactory explanation and/or correction will be made and properly disclosed."<sup>53</sup> After Applicants sent another reminder to Bidville on June 30, 2004 about amending the company's Form 10-QSB, Applicants withdrew as Bidville's auditor via a letter dated August 2, 2004. In doing so, Applicants cited the circumstances surrounding the National Securities consulting agreement, writing that Bidville's failure to account for the consulting agreement in the Form 10-QSB caused the company's financial statements "to not be 'materially correct' and not presented in accordance with generally accepted accounting principles."<sup>54</sup>

### (b) Analysis

The PCAOB found that Applicants, in connection with their fiscal year 2003 audit of Bidville, failed to properly respond after they became aware, in April 2004, of a December 2003 consulting agreement that had not been disclosed or accounted for in Bidville's 2003 financial statements, thereby violating the auditing requirements to exercise due care and to obtain sufficient competent evidence. The PCAOB also found that Applicants violated the additional auditing requirement that an auditor who becomes aware of certain facts after the issuance of his report take steps to determine if "his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements."<sup>55</sup> Under that standard, if an auditor determines that the subsequently learned facts would have affected his report, the auditor should then take action to prevent further reliance on his report.<sup>56</sup> These steps depend on the circumstances, but may include the issuance of revised financial statements and a revised auditor's report to ensure that those relying on the financial statements

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<sup>51</sup> Hr'g Officer Initial Decision at 47.

<sup>52</sup> DX-16 at 120.

<sup>53</sup> *Id.* at 125.

<sup>54</sup> RX-8 at 1. After Applicants resigned, Bidville approached Applicants about assisting with a restatement of the company's 2003 financial statements. Applicants accepted the assignment, and, on October 1, 2004, Bidville filed an amended Form 10-KSB, with the corrected financial statements recognizing the impact attributable to the consulting agreement. Applicants wrote in their audit report accompanying the financial statements that, although Bidville had previously determined that the appropriate date for recording the transaction was February 2004, the company determined, "upon further evaluation of the underlying contract, . . . that the appropriate measurement date for recording the economic transaction was the contract execution date of December 12, 2003." DX-10 at 123.

<sup>55</sup> See AU § 561.05, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

<sup>56</sup> AU § 561.06.

are notified of the effects of the subsequently discovered facts.<sup>57</sup> We agree with the PCAOB that Applicants violated these standards.

The PCAOB also found that Applicants, in connection with their review of the Form 10-QSB that Bidville filed on May 25, 2004, failed to comply with the interim auditing standards requiring them to exercise due care and professional skepticism. We also agree with that finding.

**(i) Consulting Agreement's Impact on Bidville's 2003 Financial Statements**

Applicants' reliance on Bidville's claim that consideration for the consulting agreement had not yet changed hands was a plain failure to exercise due care. Applicants believed that Bidville was engaged in a "pump and dump" scheme and that the company had hidden its consulting agreement from them.<sup>58</sup> This should have raised red flags about Bidville's trustworthiness and caused Applicants to view Bidville's representations about the consulting agreement with skepticism. Instead, Applicants' only effort to confirm Bidville's representation was to review a single, third-party transfer agent report, from which Hatfield testified he "could not ascertain" whether or not the shares had been transferred.<sup>59</sup> Applicants could have taken any number of easy, obvious follow-up steps to confirm Bidville's representations about the stock issuances, such as contacting the transfer agent directly or sending a confirmation request to the parties to the agreement. But Applicants made no such effort. Given Applicants' concerns about Bidville's trustworthiness, this failure to take simple follow-up measures to verify management's representations displayed a remarkable lack of professional skepticism.

This lack of due care again led to the related failure to obtain sufficient audit evidence on which to base an audit opinion. As the interim standards explain, "representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."<sup>60</sup> Here, Applicants relied on representations by a company Applicants did not trust and on a single, third-party transfer agent report, which Applicants admitted did not provide the assurances they needed to confirm management's representation. This evidence provided no meaningful basis from which Applicants could opine about Bidville's disclosure regarding the consulting agreement. These failures also led to Applicants' more specific auditing failure to take steps to determine if the consulting agreement would have affected their 2003 audit report had they known about the agreement at the date of that report.<sup>61</sup>

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<sup>57</sup> See *id.*

<sup>58</sup> DX-3 at 157.

<sup>59</sup> Tr. at 114.

<sup>60</sup> AU § 333.02, *Reliance on Management Representations*.

<sup>61</sup> See AU § 561.

(ii) **Consulting Agreement's Impact on Bidville's 2004 Q1 Financial Statements**

Even more troubling than the foregoing auditing failures was how Applicants responded when they learned that the consulting agreement had gone into effect in February 2004 but that Bidville still did not intend to disclose the consulting agreement's impact in its about-to-be-filed financial statements. Hatfield testified that, despite believing that Bidville was a scam and wanted to do "a pump and dump" of its stock, Applicants "rolled over" and allowed Bidville to file its quarterly report without objection.<sup>62</sup> Although Applicants eventually withdrew as Bidville's auditors, they did not do so until more than two months after learning that Bidville would be filing misstated financial statements. In the intervening time, Applicants took no steps other than sending occasional emails to Bidville management, which did nothing to prevent investors from relying on what Applicants believed were materially misstated financial statements.

Applicants based these decisions on Bidville's purported promise to file an amended quarterly report within five days. Applicants contend they accepted this promise because of Exchange Act Rule 12b-25, which provides an issuer, under certain circumstances, an additional five calendar days to file a quarterly report if the issuer timely files a Form 12b-25.<sup>63</sup> Regardless of whether Bidville filed a Form 12b-25 or a late Form 10-QSB, nothing in Rule 12b-25 provides—or even implies—that an issuer may file a materially misleading quarterly report if the issuer promises to correct that filing within five days.

Even more disturbing is that, in making this argument, Applicants imply that Bidville's filing of a materially misleading quarterly report was somehow acceptable because investors would be misled for only five days. Such an assertion displays a profound disregard for Applicants' responsibility to public investors.<sup>64</sup> A promise by Bidville to file within five days would not change Applicants' responsibility to exercise due care in ensuring that Bidville's interim financial statements could properly be relied upon by investors.<sup>65</sup> Applicants plainly failed in this duty by allowing Bidville to file without objection what Applicants believed was a materially misstated quarterly report. Nor would such a promise change Applicants' responsibility to take steps to prevent reliance on that misstated quarterly report, such as issuing a revised review report to ensure that those relying on the financial statements were notified of

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<sup>62</sup> DX-3 at 157-58

<sup>63</sup> 17 C.F.R. § 240.12b-25(a) (requiring issuers to provide notice of inability to file a periodic report, along with supporting reasons, by filing a Form 12b-25 "no later than one business day after the due date" for such report); *Id.* § 249.322 (Form 12b-25). Bidville filed a Form 12b-25 on May 17, 2004, which was eight days before the company finally filed its amended Form 10-QSB.

<sup>64</sup> See generally *United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984) (noting that independent auditors owe "ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public").

<sup>65</sup> See AU § 722.46, *Subsequent Discovery of Facts Existing at the Date of the Accountant's Report* (noting that, when discovering facts after the date of a review report, "the accountant should consider the guidance in section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*").

the effects of the subsequently discovered facts. But Applicants took no action for more than two months.

Moreover, the record offers no credible evidence that Bidville actually promised to file an amended quarterly report within five days. As the hearing officer accurately observed, "no such management representation is mentioned in Hatfield's contemporaneous emails or [Applicant]'s resignation letter."<sup>66</sup> Given the importance that Applicants place on Bidville's supposed promise, one would expect some mention of it in Applicants' audit work papers or correspondence with Bidville. Instead, the only evidence of such a promise is Applicants' own testimony, which the hearing officer found not credible, and the testimony of Bidville's outside accountant consultant, Gary Alexander, who testified only that Bidville promised to file an amended report "as quickly as we could."<sup>67</sup>

Applicants nevertheless defend their audit procedures by pointing to their expert's testimony that "it was accepted" that an auditor could wait until the next quarterly report to issue a nonreliance report if that auditor discovered a material misstatement in quarterly financial statements for which the auditor had already issued a review report.<sup>68</sup> Applicants claim this supports their decision not to object or withdraw because "a disclosure in interim statements was sufficient until the exact quantification for the adjustment could be determined."<sup>69</sup> Applicants, however, discovered the material misstatement before Bidville filed its quarterly report. Moreover, Applicants did not need additional time to quantify an exact adjustment. Applicants already knew what adjustment Bidville needed to make.

Applicants further attempt to justify their inaction by claiming that "three massive hurricanes in Florida occurred, impeding effective communications with Applicants from May 25 to August 2, 2004."<sup>70</sup> Neither the record nor Applicants' briefs indicate how such hurricanes impeded their communications or audit. To the contrary, the record shows that at least some communication existed throughout the relevant period, as the record contains email correspondence between Applicants and Bidville from this time. But this is beside the point. Any difficulty in communication does not change that Applicants admit to "rolling over"; allowing Bidville to file, without objection, what they believed were materially misstated financial statements; and taking no meaningful steps to prevent investor reliance on those financial statements for more than two months.

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<sup>66</sup> Hr'g Officer Initial Decision at 47.

<sup>67</sup> Tr. at 479.

<sup>68</sup> *Id.* at 444.

<sup>69</sup> Appellants' Br. in Supp. of Pet. for Review at 24.

<sup>70</sup> *Id.* at 23.

## **B. The Epicus Audits**

Epicus engaged Applicants to audit the company's 2002 through 2007 financial statements. Epicus was a Florida corporation, whose only active business during the relevant period was the resale of telecommunication services through a subsidiary. At issue here are certain aspects of Applicants' audits of Epicus's fiscal year 2004 and 2005 financial statements.<sup>71</sup> During these audits, Applicants again repeatedly violated multiple auditing responsibilities by relying on their own untested assumptions or on Epicus's unverified representations—despite concerns about Epicus's reliability—to reach certain auditing conclusions.

### **1. Applicants audit Epicus's 2004 revenue recognition.**

#### **(a) Background**

During their audit of Epicus's 2003 financial statements (which are not at issue here), Applicants determined that the company's revenue recognition policy did not comply with GAAP. Specifically, Applicants determined that GAAP required Epicus to recognize the income from telephone services at the time the services were provided to (or earned from) Epicus's customers.<sup>72</sup> Epicus, however, was recognizing revenue when the company billed its services to customers. Applicants recommended that, to conform to GAAP, Epicus should change its policy so that, for local and bundled services, Epicus would recognize revenue as it was earned, on a per-day basis, and, for long distance service, recognize revenue when it was provided. Applicants further recommended that Epicus (i) make the changes as of the 2003 fiscal year end; (ii) disclose the changes in a Form 10-KSB or Form 8-K; and (iii) quantify the GAAP violation's impact on the financial statements.

Instead of changing its revenue recognition policy, however, Epicus changed only its disclosure. Epicus had stated in its 2003 financial statements that the company recognized revenue on the date "of billing," but changed the disclosure in 2004 to state that Epicus recognized revenue "as earned."<sup>73</sup> Hatfield testified during his disciplinary hearing that he knew Epicus's disclosure did not accurately reflect how the company was recognizing revenue.

During the investigatory phase of these proceedings, Hatfield testified that he could not recall performing any specific analysis to determine whether this inaccurate disclosure was material.<sup>74</sup> Hatfield added that, if he had done any such materiality analysis, he would have

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<sup>71</sup> For each of the relevant years, Epicus's fiscal year ended May 31.

<sup>72</sup> During Epicus's 2004 fiscal year, the company offered three types of telephone service: (i) local, which was billed monthly in advance of service, at a flat rate; (ii) long distance, which was billed monthly after service was provided, based on calls made; and (iii) bundled, combining unlimited local and long distance service, which was billed monthly in advance of service, at a flat rate.

<sup>73</sup> Compare DX-20 at 47 with DX-21 at 54.

<sup>74</sup> See AU § 110.02, *Responsibilities and Functions of the Independent Auditor* ("The auditor has a responsibility 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.").

expected to find such analysis reflected in the work papers and that the absence of any such evidence in the work papers indicated to Hatfield that "there was nothing available for me to do."<sup>75</sup> Similarly, when responding to a notice from the PCAOB's Division of Enforcement and Investigations that it intended to recommend that the Board issue an Order Instituting Proceedings, Applicants did not dispute the Division's allegation that, among other things, Applicants had failed to conduct a materiality evaluation. Instead, Applicants claimed only that Epicus's management was unable to provide the information necessary to perform such an analysis.

Hatfield changed his testimony at his disciplinary hearing. There he claimed for the first time that Applicants had done an analysis to determine whether Epicus's inaccurate disclosure of how the company was recognizing revenue was material. Hatfield described this analysis as "a visual and mental check," which consisted of looking at Epicus's 2003 and 2004 billing cycles and "kind of just rough in my mind look[ing] to see where the difference was."<sup>76</sup> Hatfield added that, based on this rough estimation, he "did not believe at that time that [Epicus's inaccurate disclosure of its actual revenue recognition policy] would significantly misstate or distort the financial statements."<sup>77</sup>

Hatfield acknowledged he had not previously claimed to have conducted such an analysis. Hatfield further acknowledged that he could not recall what numbers he came up with during this supposed evaluation; that, whatever those numbers were, they would have exceeded the quantitative materiality thresholds Applicants had set during the audit; and that he could not recall whether he had even considered whether the results of his supposed analysis exceeded Applicants' materiality thresholds.

Applicants' expert similarly admitted during the hearing that a hypothetical work paper he had created in an attempt to duplicate Hatfield's claimed visual and mental check yielded a result that exceeded Applicants' planning materiality and tolerable misstatement thresholds. The expert argued that the amount he calculated was nevertheless not material when compared with Epicus's earning per share, but he acknowledged that such a comparison was not in Applicants' work papers.

#### **(b) Analysis**

The PCAOB found that Applicants, after learning of Epicus's GAAP violation, did not satisfy the requirement to exercise due professional care, and we agree. Applicants knew that Epicus's revenue recognition practice failed to comply with GAAP and that the interim auditing standards required them to obtain reasonable assurance that the GAAP violation was not

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<sup>75</sup> DX-4 at 35.

<sup>76</sup> Tr. at 33, 157-58.

<sup>77</sup> *Id.* at 158.



material.<sup>78</sup> The interim auditing standards also expressly warn auditors to presume a risk of material misstatement in revenue recognition due to fraud.<sup>79</sup> Despite these strictures, Applicants repeatedly admitted that they did nothing to determine whether Epicus's misstatement of the way it actually disclosed revenue was material. Only at Applicants' disciplinary hearing did Hatfield state, for the first time, that Applicants had performed a "visual and mental check."<sup>80</sup> The hearing officer observed that Hatfield "appeared uncertain and unconvinced of his own claim that he conducted a materiality evaluation" and concluded that Hatfield's "demeanor strongly suggested that his testimony in that regard was fabricated."<sup>81</sup> The hearing officer added that Hatfield "could not explain in any coherent manner how . . . he concluded that Epicus's GAAP departure was not material" given his admission that the results of his supposed materiality analysis exceeded Applicants' tolerable misstatement thresholds.<sup>82</sup> "Hatfield's inability to offer an intelligible description of the materiality assessment he claims to have conducted," the hearing officer concluded, "is additional evidence that he did not perform it."<sup>83</sup>

We defer to such credibility determinations unless the record contains substantial evidence to support overturning them.<sup>84</sup> Here, the record provides no such basis for revisiting the hearing officer's credibility finding. Instead, as the PCAOB observed, the record "provides ample reason not to credit Hatfield's testimony on this point."<sup>85</sup> Most telling is Applicants' repeated failure during the investigatory stage of these proceedings to claim to have conducted a materiality analysis. Hatfield even acknowledged that, if he had done any such materiality analysis, he would have expected to find it reflected in the work papers and that the absence of such evidence in the work papers indicated to him that "there was nothing available for me to do."<sup>86</sup>

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<sup>78</sup> AU § 110.02, *Responsibilities and Functions of the Independent Auditor* ("The auditor has a responsibility 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.").

<sup>79</sup> AU § 316.41, *Identifying Risks That May Result in a Material Misstatement Due to Fraud* ("[T]he auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.").

<sup>80</sup> Tr. at 33.

<sup>81</sup> Hr'g Officer Initial Decision at 8.

<sup>82</sup> *Id.* at 9.

<sup>83</sup> *Id.* at 10.

<sup>84</sup> *Cf., e.g., Geoffrey Ortiz*, Exchange Act Release No. 58416, 2008 WL 3891311, at \*5 & nn.14-15 (Aug. 22, 2008) ("We give great weight and deference to credibility determinations by a Hearing Panel, which can only be overcome by substantial record evidence."); *Anthony Tricarico*, Exchange Act Release No. 32356, 51 SEC 457, 1993 WL 183678, at \*3 (May 24, 1993) ("It is well settled that credibility determinations of an initial fact finder are entitled to considerable weight" and "can be overcome only where the record contains 'substantial evidence' for doing so." (citing *Universal Camera v. NLRB*, 340 U.S. 474, 496 (1950)), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000).

<sup>85</sup> PCAOB Final Decision at 4.

<sup>86</sup> DX-4 at 35. Hatfield's acknowledgment is also consistent with case law in which we have noted that "[w]e consider the absence of work papers to be evidence that the audit team did not devote substantial, if any, effort to

Furthermore, even if Applicants had performed their supposed "mental check and sight analysis," such an analysis still would not have satisfied Applicants' duty to exercise due care. Applicants characterized their supposed materiality analysis as only a cursory, "rough in [their] mind," assessment of whether Epicus's GAAP violations were material.<sup>87</sup> In any event, the amount that they claim their cursory analysis yielded was an amount that exceeded the quantitative materiality thresholds Applicants set during the audit. And when confronted during the hearing about this discrepancy between their analysis and materiality thresholds, Hatfield could not remember whether he had even considered the issue. Instead, Applicants claim they simply considered "the context of Epicus[']s financial condition and performance,"<sup>88</sup> concluded that qualitative factors did not make Epicus's misstatement material, and continued on with their audit. Even if Applicants had actually performed such an analysis, such a lackadaisical auditing approach to an area of such importance as revenue recognition would represent a clear failure to exercise due care and professional skepticism.

## **2. Applicants fail to seek confirmations related to Epicus's 2004 accounts receivable.**

### **(a) Background**

Applicants decided not to send third-party requests to confirm the approximately \$5.7 million in accounts receivable that Epicus reported in its 2004 financial statements—an amount that represented more than seventy-five percent of Epicus's reported year-end total assets.<sup>89</sup> In that financial statement, Epicus classified its accounts receivable as either (i) amounts due from residential or commercial customers; or (ii) carrier access fees due from the telecommunications companies whose services Epicus resold. For accounts receivable in the first category, Epicus further subdivided those receivables into active and inactive accounts. For receivables related to inactive accounts, Epicus assigned those receivables out for collection by either Epicus's in-house staff or outside collection agencies.<sup>90</sup>

During the hearing, Hatfield testified that Applicants were concerned about Epicus's accounts receivable because it had been a trouble area in the past, and he acknowledged the

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(...continued)

review the areas in question." *Gregory M. Dearlove, CPA*, Exchange Act Release No. 57244, 2008 WL 281105, at \*10 n.39 (Jan. 31, 2008) (noting that "workpapers are ordinarily the foundation on which support for audit conclusions is demonstrated").

<sup>87</sup> Tr. at 157.

<sup>88</sup> Appellants' Br. in Supp. of Pet. for Review at 6.

<sup>89</sup> In its Form 10-KSB, filed on October 10, 2004, Epicus reported total assets of \$7,568,803 for the fiscal year ending May 31, 2004.

<sup>90</sup> Approximately \$2.6 million of Epicus's accounts receivable was due from inactive accounts, and Epicus assigned approximately \$1 million of that amount to outside collection agencies.

importance of verifying the existence of Epicus's receivables.<sup>91</sup> Applicants' work papers included an audit program that stated, "Select those groups that will be confirmed 100 percent by the use of positive confirmation letters."<sup>92</sup> Yet Applicants did not send any letters seeking positive confirmation of the accounts receivable. Instead, Applicants sent an email to Epicus management about opting out of sending positive confirmation requests "so that time can be saved."<sup>93</sup> Applicants' work papers further explained that they decided not to send such letters because of a "[l]arge # of small accounts with little possibility of accurate response"<sup>94</sup> and because "[t]he use of positive audit confirmations is not practical due to the existence of approximately 40,000 separate accounts with no single account or group of accounts being significant within the population. Accordingly the confirmation response rate would not be cost effective."<sup>95</sup> At the hearing, however, Hatfield acknowledged that the majority of Epicus's carrier access fees were billed to only four large telecommunications companies.

### (b) Analysis

The PCAOB's interim auditing standards state that there is a "presumption that the auditor will request the confirmation of accounts receivable during an audit."<sup>96</sup> The standards define that confirmation process as "the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions."<sup>97</sup> The reason for this process, the standards explain, is that "it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity."<sup>98</sup> As a result, the standards state that "[a]n auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame this presumption."<sup>99</sup> The PCAOB found that Applicants violated this standard, along with the duty to

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<sup>91</sup> Applicants, at various times, testified and wrote in their work papers about concerns with Epicus's recordkeeping. For example, during his investigatory testimony, Hatfield described Epicus as having "sloppy bookkeeping," and Applicants wrote in their work papers that a rewrite of Epicus's accounts receivable reporting system in 2004 "created a total failure in management reporting." DX-3 at 219; DX-28 at 238. At the hearing, however, Hatfield tried to qualify these earlier comments by describing Epicus's bookkeeper as "relatively accurate and reliable" and testifying that, although the company's bookkeeping was sloppy, its cash management was not. Tr. at 63.

<sup>92</sup> DX-27 at 244.

<sup>93</sup> DX-25 at 114.

<sup>94</sup> DX-27 at 244.

<sup>95</sup> DX-28 at 238.

<sup>96</sup> AU § 330.34, *Confirmation of Accounts Receivable*.

<sup>97</sup> AU § 330.04, *Definition of the Confirmation Process* (noting that the process includes selecting items for which confirmations are to be requested; designing the confirmation request; communicating the confirmation request to the appropriate third party; obtaining the response from the third party; and evaluating the information, or lack thereof, provided by the third party about the audit objectives, including the reliability of that information).

<sup>98</sup> AU § 330.34.

<sup>99</sup> AU § 330.35, *Confirmation of Accounts Receivable*.

exercise due professional care and to obtain sufficient audit evidence, by deciding not to send positive confirmation requests and by not having a reasonable basis for making that decision. We agree.

The reason Applicants listed in their work papers for not sending out positive confirmation requests was that, because Epicus had a large number of small accounts, there was "little possibility of accurate response."<sup>100</sup> Applicants, however, did nothing to confirm the actual likelihood of an accurate response. During the hearing, Hatfield claimed that Applicants based their conclusion on their experience during audits of another, supposedly similar, municipal utility. The interim auditing standards, however, expressly state that auditors should document why they did not send positive confirmation requests,<sup>101</sup> and Applicants did not document in the work papers their reliance on past experience as a basis for not sending such requests.<sup>102</sup> Moreover, during the previous audits on which Applicants supposedly relied, Applicants never actually sent positive confirmation requests, and thus had no basis for determining the likelihood that sending such requests would yield an accurate response.<sup>103</sup> The only other audit Applicants identify that could provide some indication about the possibility of an accurate response was their failed attempt to obtain positive confirmations from Bell South during a subsequent audit. Because that audit occurred after Applicants performed the Epicus audit at issue here, however, it could not have been the basis for Applicants' determination during the Epicus audit.

Applicants' claim that seeking confirmations would have been impracticable because of Epicus's numerous small accounts does not explain their decision not to seek confirmations related to Epicus's carrier access fees. As Hatfield acknowledged at the hearing, the majority of Epicus's carrier access fees were billed to only four large telecommunications companies. Applicants argue on appeal that they had explained in their work papers that the collectability of carrier access fees was "relatively assured by statute as long as the carrier in question remains solvent and operating."<sup>104</sup> Applicants claim that, "[s]ince the carrier access fees were a statutory creation, this validates and confirms the existence of such a receivable."<sup>105</sup> Any legal requirement that carriers must pay their fees, however, does not establish that any particular carrier actually incurred such a legal obligation to Epicus, which was the point of sending positive confirmations in the first place.

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<sup>100</sup> DX-27 at 244.

<sup>101</sup> AU § 330.35 ("An auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame this presumption.").

<sup>102</sup> Cf. *Michael J. Marrie*, Exchange Act Release No. 48246, 56 SEC 760, 2003 WL 21741785, at \*12 (July 29, 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).

<sup>103</sup> See AU § 330.23, *Prior Experience* ("In determining the effectiveness and efficiency of employing confirmation procedures, the auditor may consider information from prior years' audits or audits of similar entities.").

<sup>104</sup> DX-28 at 246.

<sup>105</sup> Appellants' Br. in Supp. of Pet. for Review at 12.

As the PCAOB's expert wrote in his report, "Auditing is not a guessing game. It is based on the concept of developing corroboration for assertions."<sup>106</sup> Here, other than their unsupported belief that seeking confirmations would be ineffective and that opting out of the positive confirmation process would save time, Applicants developed no basis for deciding not to send confirmation requests. This failure to have any documented or supported basis for not sending confirmation requests represented a clear failure to exercise due care and a failure to comply with the duties regarding such confirmation requests. Not sending any confirmation requests also led directly to Applicants' related failure to obtain sufficient audit evidence because, as explained in the following section, Applicants had essentially no evidence on which to base their audit opinion regarding Epicus's accounts receivable.

### **3. Applicants use an alternative procedure for testing Epicus's accounts receivable.**

#### **(a) Background**

Instead of sending confirmations, Applicants claim they used an alternate procedure to test Epicus's accounts receivable. This alternate procedure supposedly involved Applicants' reviewing the company's year-end cash receipts from a fifty-three-day period following the close of Epicus's 2004 fiscal year. In conducting that review, Applicants did not attempt to match the cash receipts with actual receivables being paid or otherwise attempt to trace (or "vouch") any cash receipt to the receivable balance. Instead, Applicants relied on Epicus's representations about the company's experience regarding the timing of collections. But as Hatfield acknowledged during the hearing, Applicants did not test the accuracy of those representations.

Applicants nevertheless used those representations to determine that, of the cash that Epicus collected during the fifty-three-day period after the 2004 fiscal year end, approximately \$2.3 million related to Epicus's \$3.1 million in active year-end residential and commercial accounts receivable and approximately \$700,000 related to the company's \$1.5 million in carrier access accounts receivable. Hatfield acknowledged that Applicants' alternative confirmation procedure ignored the remaining \$800,000 in uncollected receivables from the residential/commercial receivables and \$800,000 in uncollected receivables from carrier access receivables—amounts that, by themselves, each exceeded Applicants' planning materiality and tolerable misstatement thresholds.

During his disciplinary hearing, Hatfield acknowledged that, because Applicants did not vouch any of the cash Epicus collected during the fifty-three-day period, their alternate procedure did not establish whether that cash actually applied to Epicus's year-end accounts receivable balance. Hatfield also admitted that their alternate procedure did nothing to test the approximately \$2.6 million of inactive customer accounts.

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<sup>106</sup> DX-40 at 30.

**(b) Analysis**

The PCAOB's interim auditing standards state that auditors should use alternative procedures when auditors, such as Applicants, do not use confirmation requests to test the existence of accounts receivable.<sup>107</sup> Under those standards, "alternative procedures may include examination of subsequent cash receipts (including matching such receipts with the actual items being paid)."<sup>108</sup> The PCAOB concluded that Applicants failed this requirement by relying on unverified management representations when testing part of Epicus's accounts receivable and by doing nothing to test Epicus's other accounts receivable. The PCAOB also concluded that these audit procedures failed to satisfy Applicants' duty to exercise due professional care and duty to obtain sufficient audit evidence. We agree.

Hatfield admitted that Applicants' alternate procedure could not establish whether the year-end payments applied to Epicus's year-end accounts receivable balance. Instead, despite various concerns with Epicus's accounting and bookkeeping, Applicants relied on management representations about the company's historical experience without testing the accuracy of those representations or determining whether Epicus's historical experience was relevant to Epicus's 2004 accounts receivable. Applicants' alternative testing procedure also ignored entirely more than twenty-five percent of Epicus's residential/commercial active accounts receivable, more than fifty percent of Epicus's carrier access receivables, and all of Epicus's inactive accounts receivable.

Applicants justify their failure to test the inactive accounts by arguing that Epicus was pursuing those inactive accounts through internal and external collections processes. This, Applicants claim, established the inactive accounts' existence because "obviously a receivable can't be turned over for collection unless it exists."<sup>109</sup> Applicants offer no basis for such a supposition, which is patently unreasonable: Issuers could recognize fabricated accounts receivable as revenue and then hide their fraudulent conduct by claiming to have turned over the aged receivable for collection. Applicants' decision to not even contact the collection agencies to see if the inactive accounts had been turned over was a clear failure to satisfy both the general requirement to exercise due care and the more specific requirement regarding the use of alternate procedures. These failures again also led to Applicants' failing to obtain sufficient audit evidence, as Applicants' flawed alternate procedures yielded essentially no reliable evidence on which to base their audit opinion regarding the existence of Epicus's accounts receivable.

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<sup>107</sup> AU § 330.31, *Alternative Procedures* ("When the auditor has not received replies to positive confirmation requests, he or she should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level."); *see also supra* notes 96–99 and accompanying text (discussing the presumption that an auditor will request the confirmation of accounts receivable during an audit).

<sup>108</sup> AU § 330.32, *Alternative Procedures*.

<sup>109</sup> Appellants' Br. in Supp. of Pet. for Review at 13.

#### 4. Applicants audit Epicus's 2004 and 2005 doubtful account allowance.

##### (a) Background

##### (i) Epicus's 2004 Accounts Receivable

In the company's 2004 financial statements, Epicus disclosed that it had approximately \$5.7 million in accounts receivable, net of approximately \$1.5 million in doubtful accounts. Hatfield testified that, during their audit of those financial statements, Applicants determined that the company had based its \$1.5 million doubtful account allowance "on a number that was pulled out of the air."<sup>110</sup> Because of this, Applicants tested the company's allowance using their own calculations. In doing so, however, Applicants did not test Epicus's carrier access fee accounts because, as noted earlier, they believed the telecommunications companies had a legal obligation to pay the fees. Applicants instead tested only Epicus's active (residential and commercial) and inactive accounts.

In auditing these accounts, Applicants accepted the company's representation that ninety percent of its accounts receivable was paid within ninety days. Once again, however, Hatfield admitted that Applicants did nothing to test Epicus's representation. Nevertheless, Applicants' work papers state that, based on the company's representation, Applicants intended to calculate Epicus's uncollectible accounts by taking "an arbitrary 10%" of the company's active accounts receivable.<sup>111</sup> Instead of using this methodology, however, Applicants decided to estimate the doubtful account allowance by applying the ten-percent factor only to *past due* active accounts receivable. And in doing so, Applicants relied on yet another untested management representation: namely, a company-prepared summary of Epicus's accounts receivable (a so-called "aging report"), which Applicants used to conclude that \$1.1 million of Epicus's \$3.1 million in active receivables were past due as of May 31, 2004. Applicants then applied the arbitrary ten percent to the aging report's \$1.1 million past due number to calculate a doubtful account allowance of approximately \$110,000. Applicants did so despite noting in their work papers that the aging report was neither "valid" nor "workable" because of a "total failure in management reporting."<sup>112</sup> Hatfield further admitted that, because the aging report was invalid, Applicants had no basis to know whether the past due amounts they calculated were actually past due.<sup>113</sup>

Furthermore, by applying the arbitrary ten percent to only \$1.1 million in active receivables, instead of the full \$3.1 million, Applicants essentially assumed that the remaining \$2 million balance was one hundred percent collectible. Hatfield acknowledged that Applicants

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<sup>110</sup> DX-4 at 55.

<sup>111</sup> DX-28 at 238.

<sup>112</sup> *Id.*

<sup>113</sup> For example, when asked during his investigatory testimony whether he was "able to verify that the amounts listed as past due by the company were actually the amounts past due," Hatfield responded, "I don't think there was a way."

made this assumption despite knowing that Epicus itself had expected not to collect at least some of that remaining \$2 million balance. Hatfield also admitted that, "in hindsight," the allowance for active account receivables "should have been 10 percent of three million one instead of one million one . . . ." <sup>114</sup>

As for calculating an appropriate allowance for Epicus's inactive accounts, Applicants assumed the company would collect fifty percent of the receivables Epicus assigned to in-house collection and would collect forty percent of the receivables assigned to outside collection agencies. Hatfield testified that these percentages were based on Applicants' own historical experience about what they "anticipated [to be] the best case scenario for collections," while acknowledging that the "[w]orst case" would be that the company collected nothing. <sup>115</sup> Applicants again did nothing to test the relevance of their historical experience to Epicus's actual situation, nor did they do anything else to verify the amount of inactive accounts, such as sending requests to the outside collection agencies to confirm whether Epicus had actually sent those accounts out for collection.

#### (ii) Epicus's 2005 Accounts Receivable

In its 2005 financial statements, Epicus reported year-end accounts receivable of approximately \$1.4 million, net of approximately \$500,000 in doubtful accounts. Epicus further disclosed that the company would retroactively write off as uncollectible any receivable amounts it did not collect within thirty days of the fiscal year end. <sup>116</sup> This disclosure was inconsistent with Epicus's representation during the 2004 audit, during which Epicus claimed it received payment on a substantial portion of receivables that the company had not collected within thirty days of the year end. Applicants nevertheless accepted Epicus's new representation about its 2005 doubtful accounts because, Hatfield testified, it "was one of the most conservative presentations that [Epicus] could develop." <sup>117</sup> Applicants wrote in their work papers, however, that "[t]he actual AR balance is much higher [than the amount collected during the 30-day period]; however, the client has no monitoring or collection protocol in place to allow any collectability reliability on delinquent AR accounts." <sup>118</sup> Hatfield testified that, as with Applicants' audit of Epicus's 2004 financial statements, Applicants did nothing during the 2005

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<sup>114</sup> Tr. at 165. Given that the company's accounts receivable was approximately \$3.1 million, Applicants methodology should have yielded a doubtful account allowance of approximately \$310,000. Again, however, we take no position as to the appropriateness of this calculation as it relates to GAAP.

<sup>115</sup> *Id.* at 164, 190.

<sup>116</sup> Epicus stated:

[T]he Company adopted the policy of recording a net accounts receivable balance equal to the actual cash collected during the 30 day period subsequent to any reporting period. Any differential between the Company's actual accounts receivable and the actual subsequent cash collections is recorded as bad debt expense in the reporting period.

DX-23 at 57-58.

<sup>117</sup> Tr. at 173.

<sup>118</sup> DX-30 at 201.



audit to test whether any of Epicus's year-end cash related to any specific receivable. Nor did Applicants send any confirmation requests to establish the existence of any receivable. Instead, Hatfield admitted that Applicants simply accepted what Epicus told them.

**(b) Analysis**

The PCAOB concluded that Applicants failed to exercise due professional care and to collect sufficient competent evidential matter during their audit of Epicus's 2004 and 2005 doubtful account allowances, and we agree. Once again, Applicants based their audit opinion on untested management representations and their own untested, undocumented historical experience.

With respect to Epicus's 2004 active accounts receivable, Applicants applied what they conceded was an arbitrary ten percent against a company-generated aging report that Applicants themselves described as invalid and unworkable. And in doing so, Applicants applied the arbitrary ten percent to only Epicus's past-due receivables, which meant that Applicants assumed that approximately two-thirds of the company's active accounts receivable was one hundred percent collectible, despite knowing that Epicus did not expect to collect some of that amount. Applicants then ignored entirely Epicus's carrier access fee receivable.<sup>119</sup>

And when calculating an appropriate allowance for Epicus's inactive accounts, Applicants relied on their own historical experience about what they expected would be "the best case scenario," while doing nothing to test the relevance of that historical experience to Epicus's specific situation. Applicants also relied on management's untested representation about assigning some of the inactive accounts to outside collection agencies. Nor did Applicants do anything else to verify the amount of Epicus's 2004 inactive accounts, such as sending confirmation requests to the outside collection agencies to confirm whether Epicus had actually sent those accounts out for collection.

Applicants took a similar approach in 2005 by again relying on Epicus's representations, but this time Applicants relied on a representation about the company's collection expectations. Applicants contend this was reasonable because they saw no evidence that would have caused them to question Epicus's 2005 representation. But management's 2005 representation was inconsistent with management's 2004 representation, and this should have caused them to question the later representation. Applicants also wrote in their work papers that Epicus has "no monitoring or collection protocol in place to allow any collectability reliability on delinquent AR accounts."<sup>120</sup> The interim standards expressly state that "[i]f a representation made by management is contradicted by other audit evidence, the auditor should investigate the

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<sup>119</sup> Applicants again argue that they ignored these receivables because telecommunication companies had a legal obligation to pay carrier access fees. As previously explained, a general legal obligation does not establish that a particular company actually owed any particular obligation to Epicus. Nor would a particular company's legal obligation necessarily mean that the company had the resources, or intention, to actually pay. *See discussion supra* Section II.B.2(b).

<sup>120</sup> DX-30 at 201.

circumstances and consider the reliability of the representation made."<sup>121</sup> But Applicants undertook no such investigation.

On appeal, Applicants claim they took a variety of additional audit steps, such as conducting a risk assessment, interviewing appropriate company personnel, finding reliable and accurate recordkeeping protocols, and testing management's representations. The record, however, contains no evidence of this. To the contrary, Hatfield repeatedly testified that Applicants relied only on untested management representations and on their own historical experience, which they did nothing to test for suitability to Epicus's particular situation. Applicants also claim that Epicus's cash receipts "provided a reasonably accurate estimate of the year end accounts receivable balance,"<sup>122</sup> but Applicants' own work papers stated Epicus's accounts receivable monitoring and collection protocol was not reliable.

## **5. Epicus changes its revenue recognition policy in 2005.**

### **(a) Background**

Epicus filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code on October 25, 2004 (*i.e.*, during Epicus's 2005 fiscal year). The company remained in operation during the bankruptcy and, in its 2005 financial statements, reported total revenue of approximately \$18.8 million for the 2005 fiscal year. Partway through the 2005 fiscal year, however, Epicus changed its revenue recognition policy. The company included a description of this new policy in its Form 10-KSB filed on September 3, 2005, but did not disclose that the policy was a change from the previous year's revenue recognition policy.<sup>123</sup> Although Applicants knew that Epicus had changed its revenue recognition policy, Applicants' work papers contain no indication that they made any attempt to determine whether that change had a material effect on the comparability of Epicus's 2004 and 2005 financial statements. To the contrary, Hatfield stated during his investigative testimony that he was not sure he had even considered whether Epicus needed to disclose the change to its revenue recognition policy. Applicants instead simply issued an unqualified audit report in connection with Epicus's 2005 Form 10-KSB without disclosing in their audit opinion that the company had changed its revenue recognition policy or what effect Epicus's change in policy had on an investor's ability to compare Epicus's 2004 and 2005 financial statements.

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<sup>121</sup> AU § 333.04.

<sup>122</sup> Appellants' Br. in Supp. of Pet. for Review at 17.

<sup>123</sup> Epicus's Form 10-KSB stated:

Revenue for services billed in advance is recognized on a pro-rata basis over the course of the related billing cycle and revenue for long distance service billed in arrears is recognized at the respective billing date. Accordingly, the Company has recognized an unearned revenue item in the accompanying balance sheet for unearned advance billings for service.

**(b) Analysis**

The PCAOB found that Applicants violated the auditing requirement that Applicants' audit report should identify those circumstances in which accounting principles were not applied consistently in a company's current reporting period in relation to the preceding period.<sup>124</sup> The PCAOB further found that, in failing this requirement, Applicants also failed to exercise due care. We agree with the PCAOB's findings.

Applicants do not dispute that they failed to evaluate whether Epicus's change to its revenue recognition policy materially affected the comparability of Epicus's 2003 and 2004 financial statements. Applicants instead argue that the relevant interim auditing standards did not apply because Epicus planned to adopt fresh start accounting pursuant to AICPA Statement of Position 90-7 ("SOP 90-7"). That provision states, "Fresh-start financial statements prepared by entities emerging from bankruptcy will not be comparable with those prepared before their plans were confirmed because they are, in fact, those of a new entity." Applicants assert that, as a result, "[f]resh start' financial statements do not need to compare change[s] in accounting policy or the material effect thereof."<sup>125</sup>

SOP 90-7, however, does not allow fresh start accounting to begin until a bankruptcy court confirms the entity's reorganization plan, and Applicants concede that the bankruptcy court did not confirm Epicus's reorganization plan until December 2005, which was after the date of Applicants' audit report. Applicants nevertheless argue that they could still consider Epicus's financial statements as a "fresh start" based on AU § 560.03, which states that "[a]ll information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based." That section is not relevant here. AU § 560.03 deals with "those events that provide additional evidence with respect to conditions *that existed at the date of the balance sheet.*" (Emphasis added). Epicus, however, was not a "new entity" as defined in SOP 90-7 at the date of Epicus's balance sheet nor at any point during Epicus's 2005 fiscal year. At the date of the balance sheet, Epicus was the same entity it had been during the 2004 fiscal year. As a result, neither SOP 90-7 nor AU § 560 excused Applicants from their obligation to ensure that their audit report identified the circumstances in which Epicus's accounting principles were not applied consistently during the 2005 fiscal year or in relation to the preceding periods.

<sup>124</sup> AU § 420.01, *Consistency of Application of Generally Accepted Accounting Principles* (stating that an auditors' report "shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period"). AU § 420.02 explains:

The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (a) no change in accounting principles has occurred, or (b) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor would not refer to consistency in his report.

<sup>125</sup> Appellants' Br. in Supp. of Pet. for Review at 16.

Moreover, Applicants' argument about AU § 560.03 is simply an after-the-fact excuse. Hatfield admitted that he could not recall even considering the implications of Epicus's change in revenue policy, and nothing in the record indicates that Applicants actually did so. To not even consider these factors was a complete failure to comply with the general auditing requirement to exercise due care and with the more specific requirement to consider such changes in a company's revenue recognition policy.

### III.

Based on the above violations, the PCAOB found that it would be in the public interest to permanently revoke the Firm's registration and permanently bar Hatfield from associating with any registered public accounting firm. Section 107(c)(3) of Sarbanes-Oxley directs us to sustain the PCAOB's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.<sup>126</sup> As part of our review, we "may enhance, modify, cancel, reduce, or require the remission of a sanction imposed by the Board upon a registered public accounting firm or associated person thereof."<sup>127</sup> Applying that standard, we sustain the PCAOB's imposition of sanctions.

As a preliminary matter, we note that Applicants take issue with a footnote in the PCAOB's decision, which states that "[c]ertain members of the Board participated in this decision without having been present for the oral argument before the Board on July 27, 2010. Pursuant to PCAOB Rule 5463(d), each such Board member reviewed the transcript of the oral argument prior to such participation."<sup>128</sup> Applicants argue that, "[i]f any member of the PCAOB only reviewed the transcript of the oral argument of July 27, 2010, and did not read and consider the transcript and all exhibits from the July 28-29, 2009 hearing, then Applicants have not had a full and fair review—and due process rights have not been afforded to Applicants."<sup>129</sup> But nothing in the language of either PCAOB Rule 5463(d) or the PCAOB's decision suggests that the Board members who participated in the decision did not appropriately consider the record in this matter. Rather, Rule 5463(d) is intended simply to ensure that Board members who do not

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<sup>126</sup> 15 U.S.C. § 7217(c)(2) (stating that the provisions of Exchange Act § 19(e)(1), 15 U.S.C. 78s (e)(1), "shall govern the review by the Commission of final disciplinary sanctions imposed by the Board . . . as fully as if the Board were a self-regulatory organization and the Commission were the appropriate regulatory agency for such organization for purposes of [§ 19(e)(1)]").

<sup>127</sup> 15 U.S.C. § 7217(c)(3).

<sup>128</sup> PCAOB Final Decision at 27 n.25. PCAOB Rule 5463(d) provides, "A member of the Board who was not present at the oral argument may participate in the decision of the proceeding, provided that the member has reviewed the transcript of such argument prior to such participation. The decision shall state whether the required review was made."

<sup>129</sup> Appellants' Br. in Supp. of Pet. for Review at 28.

attend oral arguments review the transcript of the argument. Our rules provide for a similar procedure.<sup>130</sup>

**A. Applicants' conduct was reckless and often knowing.**

Under § 105(c)(5) of Sarbanes-Oxley, the PCAOB may impose a revocation or bar only for "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard."<sup>131</sup> Recklessness represents an "extreme departure from the standards of ordinary care, . . . which presents a danger" to investors or the markets "that is either known to the (actor) or is so obvious that the actor must have been aware of it."<sup>132</sup> Here, the applicable standard of care against which we measure Applicants' conduct is provided by PCAOB's interim auditing standards,<sup>133</sup> and as the PCAOB accurately observed, the record is "replete with examples of [Applicants'] extreme departures" from that standard of care.<sup>134</sup> If anything, the PCAOB understated the extent of Applicants' auditing failures.

Applicants' most alarming departure from the standard of care was their decision, as Hatfield testified, to "roll[] over" and allow Bidville to file quarterly financial statements, without objection, that Applicants believed were materially misstated.<sup>135</sup> And Applicants did so despite their stated belief that the company was a "scam" and "want[ed] to get filings into the marketplace as quick as possible so that they can do smoke-and-mirror fluffing press releases to pump the stock." Bidville's filing therefore should have set off alarm bells. Other than sending an occasional email to Bidville's management, however, Applicants did nothing for months to prevent investors from relying on the company's misstated financial statements.

Applicants' claim that they took comfort from Bidville's supposed promise to file corrected financial statements within five days is likewise very troubling. Applicants' apparent belief that it is acceptable for investors to be misled for five days, and to knowingly allow false documents to be filed with the Commission, reflects a serious misunderstanding of their auditing responsibilities. Hatfield essentially "held his nose, closed his eyes, and signed off on [Bidville's financial statements], even though the circumstances surrounding [Bidville's filing] plainly

<sup>130</sup> Commission Rule of Practice 451(d), 17 C.F.R. § 201.451(d) ("A member of the Commission who was not present at the oral argument may participate in the decision of the proceeding, provided that the member has reviewed the transcript of such argument prior to such participation. The decision shall state whether the required review was made.").

<sup>131</sup> 15 U.S.C. § 7215(c)(5).

<sup>132</sup> *Gately & Assocs.*, Exchange Act Release No. 62656, 2010 WL 3071900, at \*11 (Aug. 5, 2010) (parentheses in original) (quoting *Amendment to Rule 102(e) of the Commission's Rules of Practice*, Securities Act Release No. 7593, 63 Fed. Reg. 57,164, 1998 WL 729201, at \*6 (Oct. 26, 1998)).

<sup>133</sup> *Cf. Dearlove*, 2008 WL 281105, at \*5 (noting that, when disciplining accountants under Rule 102(e), the Commission has consistently measured auditors' conduct by their adherence to or deviation from generally accepted auditing standards).

<sup>134</sup> PCAOB Final Decision at 25.

<sup>135</sup> DX-3 at 158.

required . . . a disclaimer."<sup>136</sup> This represented "an egregious refusal to see the obvious or investigate the doubtful by any measure."<sup>137</sup>

Applicants' repeated reliance on their specialized experience auditing "microcap" and "nanocap" companies like Bidville and Epicus as an excuse not to undertake appropriate audit procedures was similarly problematic. Perhaps the most notable example of this was Applicants' recommendation that Bidville report its private placement as a compensation expense. Applicants did so without actually believing the private placement was a compensation expense. And they made the recommendation based entirely on what they and other auditors had supposedly done in the past with respect to different companies and different private placements. Applicants did nothing to investigate whether that experience was analogous or otherwise relevant to Bidville's situation.

Applicants' audit of Epicus provided examples of similarly reckless and knowing auditing failures. Applicants, for instance, failed to perform any materiality analysis of what Applicants believed was an inaccurate disclosure of Epicus's policy for recognizing revenue despite knowing that improper revenue recognition was always presumed to be a risk of material misstatement due to fraud. Applicants similarly decided not to send any confirmation requests to test Epicus's accounts receivable balance based on their untested belief that such requests would be ineffective and their judgment that skipping this necessary auditing step was permissible in order to save time. Applicants instead used an alternative procedure that ignored entire portions of the company's accounts receivable, without any valid justification for doing so. And for the portion Applicants did test, Applicants again relied entirely on untested assumptions and management representations about the company's year-end payments, despite Applicants' acknowledgement that Applicants never established whether those payments actually applied to Epicus's accounts receivable balance. Applicants similarly ignored a significant portion of Epicus's accounts receivable when testing Epicus's allowance for doubtful accounts, instead blindly relying, yet again, on untested management representations, despite Applicants' belief that Epicus's accounts receivable collection was not reliable. Applicants further admitted they never even considered the impact of Epicus's change to its revenue recognition policy during their audit.

Any one of these auditing failures would constitute a clear departure from the standards of ordinary care. This is not, however, an instance, as Applicants claim, of the PCAOB "bootstrap[ing] its way to victory . . . by stringing together separate acts of auditing negligence."<sup>138</sup> Each of Applicants' auditing failures, by itself, represented a reckless or knowing failure to adhere to the PCAOB's interim auditing standards. But Applicants' repeated reliance on untested representations from audit clients about which Applicants had serious questions amounted to a particularly egregious failure to comply with their professional obligations. Such

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<sup>136</sup> *Barrie C. Scuttilo*, Exchange Act Release No. 48238, 56 SEC 714, 2003 WL 21738818, at \*9 (July 28, 2003) (finding auditor's failure to obtain sufficient competent evidence to be reckless).

<sup>137</sup> *Id.*

<sup>138</sup> Appellants' Br. in Supp. of Pet. for Review at 25.

a cavalier approach to the auditing standards "presented a risk of harm to investors and the markets that was so obvious that Applicants must have been aware of it."<sup>139</sup>

On appeal, Applicants argue that "the type of recklessness that is actionable against an outside auditor must approximate an actual intent to aid in the fraud being perpetrated by the audited company."<sup>140</sup> To the contrary, we have previously noted that "the standards of professional practice are not fraud based."<sup>141</sup> Applicants also argue that no evidence exists that their "alleged audit failures were material enough to impact whether a reasonable shareholder/investor would have considered such item important."<sup>142</sup> But whether Bidville or Epicus ultimately filed materially misleading financial statements is not the issue. An auditor "is not a guarantor of the accuracy of financial statements of public companies."<sup>143</sup> Instead, auditors are tasked with auditing public companies "diligently and with a reasonable degree of competence."<sup>144</sup> Applicants fell woefully short of that mark by repeatedly relying on what, at most, amounted to untested speculation and guesswork.

Nor are we persuaded by Applicants' arguments that the record contains no evidence of harm to investors or of an SEC investigation into Epicus's accounting. The existence of investor harm or an SEC investigation is irrelevant to the issue here, which is whether Applicants performed their audit diligently and with a reasonable degree of competence. Applicants' argument misconstrues the significance of their auditing failures. As we have noted, "[t]he fact that the Board could not identify whether there was specific harm to a particular investor does not detract from the seriousness of the misconduct."<sup>145</sup> In other words, our inquiry is not whether Applicants' failures actually harmed investors. Our inquiry is whether Applicants' conduct created a risk of such harm. Here, Applicants' repeated and nearly complete failures to perform adequate audit procedures created an obvious, significant, and ongoing risk to investors.

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<sup>139</sup> *Gately & Assocs.*, 2010 WL 3071900, at \*12.

<sup>140</sup> Appellants' Br. in Supp. of Pet. for Review at 25.

<sup>141</sup> *Amendment to Rule 102(e)*, 1998 WL 729201 at \*6; *see also Marrie*, 2003 WL 21741785, at \*7 (rejecting applicant's claim that, to establish recklessness under Rule 102(e), the Division of Enforcement "must show a type of recklessness that approximates an actual intent to aid in the fraud being perpetrated by the audited company"); *cf. Gately & Assocs.*, 2010 WL 3071900, at \*11 (noting that "our interpretations of the [Commission] Rule [of Practice]102(e) standards inform our analysis under Sarbanes-Oxley Section 105(c)(5)").

<sup>142</sup> Appellants' Br. in Supp. of Pet. for Review at 27.

<sup>143</sup> *See Marrie*, 2003 WL 21741785, at \*17.

<sup>144</sup> *Touche Ross & Co. v. SEC*, 609 F.2d 570, 581 (2d Cir. 1979).

<sup>145</sup> *Cf. R.E. Bassie & Co.*, Accounting and Auditing Enforcement Release No. 3354, 2012 WL 90269, at \*12 (Jan. 10, 2012) (citing *PAZ Sec., Inc.*, Exchange Act Release No. 57656, 2008 WL 1697153, at \*5 (Apr. 11, 2008) ("[A] Rule 8210 violation will rarely, in itself, result in direct harm to a customer. Rather, failing to respond undermines NASD's ability to detect misconduct that may have occurred and that may have resulted in harm to investors . . . . Thus, even if the failure to respond does not result in . . . harm to investors, it is serious because it impedes detection of such violative conduct." (footnote omitted)), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009) and *Gately & Assocs.*, 2010 WL 3071900, at \*14 (noting that the absence of fraud or deceit does not diminish seriousness of a failure to cooperate in PCAOB inspection that is designed, among other things, to uncover any such misconduct)).

For the same reason, we reject Applicants' argument that Bidville's misstatements in its financial statements "did not occur due to an audit failure, but due to Company management's intentional withholding of documents and subsequent consistent misrepresentations to the auditor."<sup>146</sup> Whether the companies withheld documents or made misrepresentations, however, did not relieve Applicants of their auditing responsibilities described in this opinion.<sup>147</sup> We are similarly unpersuaded by Applicants' attempts to diminish their auditing failures by returning to the fact that they required Epicus to increase its reserves for bad debt exposure.<sup>148</sup> Applicants were not freed from the many auditing requirements they inexcusably ignored simply because Epicus increased its reserve for bad debt. Indeed, Applicants' apparent contrary belief confirms the Board's and our finding that Applicants fundamentally misunderstand what is necessary to satisfy an auditor's responsibility to exercise due care.

### **B. Revocation and bar are appropriate remedial sanctions.**

Having determined that Applicants' conduct was at least reckless, the Board concluded that it was in the public interest to permanently revoke the Firm's registration and to permanently bar Hatfield from associating with any registered public accounting firm. We review that determination "having due regard for the public interest and the protection of investors,"<sup>149</sup> based on both "the nature of the violation and the mitigating factors presented in the record."<sup>150</sup> In doing so, we are mindful of the responsibility to be "particularly careful to address potentially mitigating factors"<sup>151</sup> and the "remedial and protective efficacy" of sanctions involving expulsion of a firm or individual from the auditing industry.<sup>152</sup>

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<sup>146</sup> Appellants' Br. in Supp. of Pet. for Review at 23.

<sup>147</sup> Cf. *Michael S. Hope, CPA*, Exchange Act Release No. 23513A, 49 SEC 568, 1986 WL 73230, at \*31 (Aug. 6, 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.*, Securities Act Release No. 5459, 45 SEC 469, 1974 WL 161425, at \*1 (Feb. 25, 1974) (finding that "deception . . . did not relieve Touche of its responsibility to perform its audits in conformity with generally accepted auditing standards").

<sup>148</sup> Applicants argue, for instance, that they "required Epicus to increase the reserve for bad debt exposure, and then to concurrently write off, and recognize, the portion of accounts receivable that were never to be collected." Appellants' Br. in Supp. of Pet. for Review at 9. "These adjustments," Applicants claim, "mitigate any materiality of the GAAP non-compliance amount." *Id.* The issue, however, is not whether Epicus's GAAP violation was ultimately material to its financial statements or whether Epicus had increased its reserves for bad debt. The issue is whether Applicants exercised due care with respect to their obligation to obtain reasonable assurance that Epicus's financial statements were free of material misstatement—an obligation Applicants repeatedly failed to meet for the reasons discussed above.

<sup>149</sup> 15 U.S.C. § 7217(c)(2)-(3).

<sup>150</sup> *Gately & Assocs.*, 2010 WL 3071900, at \*13 (quoting *McCarthy v. SEC*, 406 F.3d 179, 190 (2d Cir. 2005)).

<sup>151</sup> *Id.* at \*13 (quoting *Paz Sec. Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007)).

<sup>152</sup> *Id.* at \*13 (quoting *McCarthy v. SEC*, 406 F.3d at 190). *But see Paz Sec. Inc. v. SEC*, 566 F.3d 1172, 1176 (D.C. Cir. 2009) (stating that the remedial analysis regarding a bar from association with any SRO member firm does not require the Commission to "state why a lesser sanction would be insufficient").



The public interest here weighs heavily in favor of revocation and a bar. As we have noted in the analogous Rule 102(e) context, 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."<sup>153</sup> Because of this, regulators and the investing public must "rely heavily on accountants to assure corporate compliance with federal securities law requirements and disclosure of accurate and reliable financial information."<sup>154</sup> Here, Applicants were responsible for auditing the financial statements of two public companies. During those audits, however, Applicants repeatedly deferred to their clients' unsupported representations and to Applicants' own experience with other, different auditing clients, while doing nothing to test those assumptions and representations—despite various red flags about Bidville's trustworthiness and Epicus's reliability that should have alerted Applicants that added inquiry or verification was needed. Applicants' egregious and repeated failures to comply with auditing standards "jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors."<sup>155</sup> Applicants also acted with a high degree of scienter. They were experienced auditors, who nevertheless knowingly, intentionally, and repeatedly failed to exercise the basic professional skepticism and due care that are the touchstones of an auditor's responsibilities.<sup>156</sup>

As the D.C. Circuit has recognized, "the existence of a violation raises an inference that it will be repeated,"<sup>157</sup> and Applicants have made clear they intend to remain auditors if permitted. Applicants' conduct creates a substantial risk that they will commit similar violations in the future. Particularly worrying is Applicants' refusal to recognize the wrongfulness of their conduct. Despite their repeated admissions about failing to take basic auditing steps, Applicants have consistently asserted that they planned and conducted their audits appropriately. For example, Applicants claim that there "was no instance" where Applicants "skip[ped] procedures designed to test a company's reports or look[ed] the other way despite suspicions."<sup>158</sup> Nor, Applicants claim, was there an instance where they "surrendered professional judgment to the demands of the client" or "failed to investigate the doubtful."<sup>159</sup> For all the reasons detailed above, we disagree. That Applicants admit all of the facts forming the bases of their departures from professional standards without grasping the extent of their wrongdoing raises serious

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<sup>153</sup> *Amendment to Rule 102(e)*, 1998 WL 729201, at \*4.

<sup>154</sup> *Id.*

<sup>155</sup> *Touche Ross & Co.*, 609 F.2d at 581.

<sup>156</sup> Among the instances of such knowing misconduct discussed above, the most egregious example was Applicants' decision to allow Bidville to file, without objection, what Applicants believed were materially misstated financial statements and then to do nothing for more than two months to prevent investors from relying on those misstated financial statements—all based on Bidville's promise to file an amended filing within five days.

<sup>157</sup> *Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004) (affirming violation of Securities Act § 5 and related cease-and-desist order).

<sup>158</sup> Appellants' Br. in Supp. of Pet. for Review at 26 (quoting *Marrie v. SEC*, 374 F.3d 1196, 1206 (D.C. Cir. 2004)).

<sup>159</sup> *Id.*

questions about their ability to comply with those standards in the future. Worse, Applicants have insisted that the audit procedures they utilized in their Bidville and Epicus audits are the same procedures they have used in many other audits, apparently unaware of the negative implications of essentially admitting to having departed from the professional standards of care in more than just the audits at issue here.

We also find no mitigating factors that weigh against imposing a revocation or a bar. Although Applicants argue that "[w]ith unlimited time and budget, the Applicants might have been able to undertake all the steps PCAOB . . . complains were not taken,"<sup>160</sup> we find no evidence that Applicants' failures were due to time or budgetary constraints. Nor are we persuaded by Applicants' argument that the bar and revocation are more severe sanctions than the PCAOB has imposed in settled cases in which Applicants claim the misconduct was "significantly more egregious than complained of here."<sup>161</sup> Applicants do not identify any particular settled case, let alone explain how the conduct in any such case was more egregious than their conduct here. Applicants instead simply contend more broadly that the record contains no evidence "that the three audited financial statements were materially misstated, in any respect, nor that Applicants' effort did not protect the public interest."<sup>162</sup> As we have already explained, however, this is exactly what occurred here.<sup>163</sup> Such behavior by an auditor as set forth above cannot, in any sense, be described as protecting the public interest. In any event, the appropriateness of a bar and revocation do not turn on whether the financial statements were materially misstated. The inquiry is whether Applicants exercised due professional care in the performance of their audit.<sup>164</sup> And as we have explained, Applicants repeatedly failed to exercise such care.

"[T]he appropriate sanction depends upon the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings."<sup>165</sup> Moreover, comparisons to settled cases are not relevant to our sanction analysis here because auditors "who offer to settle may properly receive lesser sanctions than they otherwise might have."<sup>166</sup> Settled cases "take into account pragmatic considerations such as the

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<sup>160</sup> *Id.* at 27.

<sup>161</sup> *Id.* at 26.

<sup>162</sup> Appellants' Reply Br. at 7.

<sup>163</sup> *See, e.g., supra* Section II.A.2.(b)(ii) (discussing how Applicants allowed Bidville to file, without objection, what Applicants believed to be a materially misstated quarterly report).

<sup>164</sup> AU § 150.02 ("Due professional care is to be exercised in the performance of the audit and the preparation of the report"); AU § 722.02, *Interim Financial Information* (noting that the three general standards discussed in AU § 150.02 are applicable to a review of interim financial information).

<sup>165</sup> *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at \*17 n.68 (Dec. 19, 2008) (quoting *Christopher J. Benz*, Exchange Act Release No. 38440, 52 SEC 1280, 1997 WL 137027, at \*4 (March 26, 1997), *petition denied*, 168 F.3d 478 (3d Cir. 1988) (Table)).

<sup>166</sup> *Michael C. Pattison, CPA*, Exchange Act Release No. 67900, 2012 WL 4320146, at \*11 (Sept. 20, 2012).

avoidance of time-and-manpower-consuming adversary proceedings."<sup>167</sup> Litigated cases, by comparison, typically present a fuller, more developed record of facts and circumstances for purposes of assessing appropriate sanctions than do settled matters.<sup>168</sup> Here, we have made extensive findings about Applicants' departures from the standards of care and carefully considered the public interest.

After weighing all of these considerations, we thus conclude that a bar and revocation are necessary to protect the public interest.<sup>169</sup> These sanctions are needed to protect the integrity of the Commission's processes and encourage more rigorous compliance with auditing standards both by Applicants and by other independent auditors. We accordingly find that PCAOB's decision to revoke the Firm's registration and permanently bar Hatfield from association with a registered public accounting firm is neither excessive nor oppressive and that the sanctions serve a remedial rather than a punitive purpose. An appropriate order will issue.<sup>170</sup>

By the Commission (Commissioners WALTER, PAREDES and GALLAGHER); Chair WHITE and Commissioner AGUILAR not participating.

Elizabeth M. Murphy  
Secretary

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<sup>167</sup> *Joseph John Vancook*, Exchange Act Release No. 61039A, 2009 WL 4005083, at \*19 (Nov. 20, 2009) (noting that settled cases "cannot be meaningfully compared to the sanctions imposed in litigated cases").

<sup>168</sup> *Pattison*, 2012 WL 4320146, at \*12.

<sup>169</sup> While the PCAOB found, as we do, that Applicants engaged in reckless conduct, it also found that Applicants "engaged in repeated instances of conduct that was at least negligent, each resulting in a violation of the applicable statutory, regulatory, or professional standard." PCAOB Final Decision at 26 n.21. Given that negligence "is the failure to exercise reasonable care or competence," we find that, for all the reasons stated herein, Applicants' repeated failures to comply with the interim auditing standards clearly established that they engaged in repeated instances of conduct that was, at a minimum, negligent. *Byron G. Borgardt*, Securities Act Release No. 8274, 56 SEC 999, 2003 WL 22016313, at \*10 (Aug. 25, 2003) (defining negligence). Repeated instances of negligent conduct can also support a bar and revocation, and given the scope of Applicants' repeated auditing failures, we find, for all the reasons stated herein, that such sanctions are appropriate here regardless of whether Applicants' conduct is deemed to be knowing, reckless, or negligent.

<sup>170</sup> 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.

UNITED STATES OF AMERICA  
before the  
SECURITIES AND EXCHANGE COMMISSION

ACCOUNTING AND AUDITING ENFORCEMENT  
Rel. No. 69930 / July 3, 2013

Admin. Proc. File No. 3-14795

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S.W. HATFIELD, C.P.A.  
and  
SCOTT W. HATFIELD, C.P.A.  
c/o John A. Koepke  
Jackson Walker L.L.P.  
901 Main St., Ste. 6000  
Dallas, TX 75202

For Review of Disciplinary Action Taken by

PCAOB

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ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY PUBLIC COMPANY  
ACCOUNTING OVERSIGHT BOARD

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

ORDERED that the PCAOB's disciplinary actions taken against S.W. Hatfield, C.P.A.,  
and Scott W. Hatfield, C.P.A., be sustained.

By the Commission.

Elizabeth M. Murphy  
Secretary

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