

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71117 / December 18, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3519 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15651

In the Matter of

James Vincent Poti, CPA,

Respondent.

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

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against James Vincent Poti, CPA (the "Respondent" or "Poti") pursuant to Section 4C¹ [15 U.S.C. § 78d-3] of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 102(e)(1)(ii)² of the Commission's Rules of Practice [17 C.F.R. § 201.102(e)(1)(ii)].

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and

¹ Section 4C provides, in relevant part, that "[t]he Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found to . . . have engaged in . . . improper professional conduct"

² Rule 102(e)(1)(ii) provides, in pertinent part, that "[t]he Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in . . . improper professional conduct."

Rule 102(e) of the Commission’s Rules of Practice, Making Findings, and Imposing Remedial Sanctions (the “Order”), as set forth below.

III.

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

A. Summary

1. Poti engaged in improper professional conduct during Witt Mares, PLC’s (“Witt Mares”) 2008 year-end audit of Commonwealth Bankshares, Inc., the holding company for Bank of the Commonwealth (collectively, “Commonwealth” or the “Bank”). He did so by failing to subject Commonwealth’s loan loss estimates – one of the audit areas that Witt Mares identified as higher risk – to appropriate scrutiny. As engagement partner on the audit since 2006, Poti had ultimate responsibility for the audit decisions, the audit programs, the review of audit work papers, and the failures to follow the Public Company Accounting Oversight Board (the “PCAOB”) audit standards that are the subject of this proceeding.⁴

2. Beginning in 2006, Commonwealth – then a small Norfolk, Virginia-based community bank – embarked on a strategic plan to accumulate assets over \$1 billion. It did so by lending more and more money to construction and development projects in Norfolk, Hampton, Newport News, Chesapeake, Portsmouth and Virginia Beach, Virginia. At the same time that Commonwealth underwrote more and more construction and development loans on its quest to become a billion-dollar bank, those cities began to show signs of distress. During 2008, as a result of the financial crisis and related real estate market crash, the construction and development projects funded by Commonwealth began to flounder and Commonwealth experienced a dramatic increase in the number of its troubled real estate loans. Commonwealth’s classified loans – loans that could expose Commonwealth to partial or complete loss – had increased over the course of a year from approximately \$8 million to \$80 million – a tenfold increase. The dramatic run-up of these so-called classified loans – a major component of Commonwealth’s loan losses – coincided with a significant lack of critical information necessary to assess potential losses in its loan portfolio. Specifically, Commonwealth lacked current appraisals on the collateral securing the loans and financial information on the guarantors behind the loans.

3. Poti was well aware of Commonwealth’s loan documentation problems and the effect of these issues on the estimation of loan losses. In fact, since at least 2006, the Witt Mares audit team, under Poti’s supervision, as well as Commonwealth’s primary regulators, had repeatedly criticized the Bank’s Board of Directors and management that the failure to obtain and update critical information in Commonwealth’s loan files posed a concern. During the 2008 audit, Poti and the other members of the audit team identified the loan loss reserves as presenting

³ The findings herein are made pursuant to Respondent’s Offer and are not binding on any other person or entity in this or any other proceeding.

⁴ All citations to PCAOB auditing standards refer to the standards in effect at the time of the conduct discussed herein.

significant risk of material misstatement and fraud risk. Notwithstanding the audit team's identification of the loan loss reserve as a potentially significant problem area, the actual audit work in this area was inadequate and the resulting audit opinion was not supported by reliable or persuasive evidence. In fact, based on the audit tests of the troubled loans, the audit team concluded that, for a significant percentage of the loans reviewed, there was "[i]nadequate financial information in [the] file to determine if additional reserve is necessary." Despite this and other audit-identified issues that are detailed below, Poti authorized the issuance of an unqualified audit opinion on Commonwealth's financial statements and internal control over financial reporting for the year ended December 31, 2008.

4. In sum, Poti failed to obtain sufficient, competent evidential matter to support the issuance of unqualified audit opinions. He further failed to act with due professional care and to exercise professional skepticism. These failures, detailed below, resulted in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

B. Respondent

5. **James Vincent Poti, CPA**, age 63, is a resident of Midlothian, Virginia. Poti has been an auditor and partner at PBMares, LLP since the firm was formed on January 1, 2013 through the merger of PBGH LLP and Witt Mares, PLC ("Witt Mares"), and an auditor and partner at Witt Mares from November 2002 until the merger. Poti was a member of the Commonwealth audit team from 2006 through September 23, 2011, when federal and state banking regulators closed Commonwealth's banking subsidiary, and was the engagement partner for the 2008 audit. As engagement partner, Poti was responsible for the audit and its performance, for proper supervision of the work of the audit team members, and for compliance with PCAOB standards. Poti is currently licensed as a CPA in Virginia and has no disciplinary history.

C. Other Relevant Entities

6. **Commonwealth Bankshares, Inc.** ("Commonwealth" or the "Bank"), formerly a Virginia corporation, was, during the relevant time period, a holding company for Bank of the Commonwealth, a Virginia state-chartered commercial bank headquartered in Norfolk, Virginia. Commonwealth's common stock was initially registered with the Commission pursuant to Section 12(g) of the Exchange Act and was quoted on the NASDAQ National Market under the stock symbol "CWBS." On July 31, 2006, after the NASDAQ became a national exchange, pursuant to Commission global order, all NASDAQ National Market issuers became Section 12(b) registrants listed on the new NASDAQ Global Market ("NASDAQ"). On September 23, 2011, the Virginia State Corporation Commission's Bureau of Financial Institutions (the "SCC") and the Federal Deposit Insurance Corporation (the "FDIC"), which insured the deposits held by the Bank, closed the Bank and entered into a purchase and assumption agreement with a subsidiary of a privately held bank holding company to assume the deposits of the Bank. On November 10, 2011, NASDAQ filed a Form 25 with the Commission, in which it stated that it had delisted Commonwealth's common stock from the NASDAQ exchange for failing to satisfy the exchange's requirements effective on November 21, 2011 and deregistered it from Section 12(b), effective 90 days after the filing of the Form 25. After the effective date of NASDAQ's deregistration of

Commonwealth from Section 12(b), Commonwealth reverted to its prior Section 12(g) registration. Commonwealth remained an inactive corporate entity until May 31, 2013, when the SCC terminated Commonwealth's corporate registration. On July 31, 2013, the Commission revoked Commonwealth Section 12(g) registration by consent.

7. **Witt Mares, PLC** ("Witt Mares") was, during the relevant time period, a public limited company headquartered in Richmond, Virginia engaged in the business of providing accounting and auditing services. Witt Mares audited Commonwealth's financial statements and internal control over financial reporting for the year ended December 31, 2008 and issued unqualified opinions. On January 1, 2013, Witt Mares merged with PBGH LLP to form PBMares, LLP.

D. Commonwealth's Troubled Loan Portfolio and the Failure of the Bank

8. Commonwealth was a Norfolk, Virginia-based bank that had historically focused on commercial banking and residential loans. By 2006, Commonwealth's assets had grown to approximately \$715 million, of which the Bank's loan portfolio accounted for \$670 million.

9. In July 2006, Commonwealth adopted a strategic plan to reach one billion in assets by December 31, 2009. As part of this goal, Commonwealth began to make substantially more construction and development loans than it previously had made. By December 31, 2006, Commonwealth's exposure to such loans climbed to approximately \$179 million, or 27%, of gross loans. Commonwealth's exposure to commercial and construction and development loans continued to climb in 2007 and 2008, when its exposure to such loans amounted to approximately \$223 million, or 28%, and \$295 million, or 29%, of gross loans, respectively. Virtually all of Commonwealth's construction and development loans related to properties located in Norfolk and Virginia Beach, Virginia.

10. Beginning in or about 2006, the Norfolk commercial real estate market began to show signs of distress. As time progressed, the market trends grew worse. Condominiums and office space were particularly hit. At the end of 2008, office space and condominium prices were both down approximately 10% from 2007 nationally. At the end of 2009, the trend had deteriorated for these two categories of real estate, with office space prices down approximately 23% and condominium prices down approximately 22% nationally.

11. The decline in Norfolk's commercial real estate market had a direct impact on Commonwealth's allowance for loan and lease losses (the "ALLL") during the relevant period. The ALLL is an estimate of probable losses that reduces the book value of loans and leases to the amount that is expected to be collected. The ALLL is a material financial metric for banks, like Commonwealth, whose principal assets are loans. Inasmuch as the ALLL represents the Bank's assessment of probable losses on its loans, increases to the ALLL reflect an assessed deterioration of its loan portfolio. In addition, any increase in the ALLL (a balance sheet item) is accompanied by the recording of a provision for loan losses (an income statement item), thereby impacting a company's reported income or losses.

12. Commonwealth's ALLL principally had two components – smaller, homogeneous loans that were pooled and accorded generalized treatment under the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards⁵ No. 5 ("FAS 5") and larger and non-homogeneous loans – typically development and construction loans – that were individually analyzed under Statement of Financial Accounting Standards No. 114 ("FAS 114"). Throughout 2008, Commonwealth experienced a dramatic rise in high-risk problem loans that were deemed "impaired" pursuant to FAS 114, meaning it was probable the Bank would not recover all amounts contractually due. In fact, the portion of Commonwealth's ALLL that was attributed to FAS 114 impaired loans grew from approximately \$3 million as of December 31, 2006 to more than \$21 million as of December 31, 2008.

13. A key consideration in assessing the amount of ALLL required for impaired loans is the "fair value" of the collateral. Although GAAP does not specify the precise manner in which fair value is to be determined, fair value is measured from the perspective of factors considered by market participants. In commercial real estate, a current appraisal provides persuasive evidence of current market conditions on the appraised value of collateral.⁶ Commonwealth's Credit Policy Manual provided that a written appraisal was the only way to determine the fair value of collateral securing collateral-dependent loans. Notwithstanding these considerations and Commonwealth's own policies, Witt Mares and Commonwealth's banking regulators found that the Bank lacked current appraisals for a significant percentage of collateral-dependent impaired loans.

14. Current financial information for borrowers and guarantors also is critical for evaluating the condition of a loan. Guarantor financial information is particularly important for impaired loans where the fair value of the collateral securing the loan was less than the unpaid principal balance on the loan because, in the event the borrower defaults and the fair value of the collateral is not enough to satisfy the loan's unpaid principal balance, the bank can seek to satisfy the remaining balance from the guarantor. The absence of current and complete guarantor financial information makes it difficult for the bank to assess whether the guarantor is in a position to make the bank whole if the collateral is not enough to satisfy the loan. Recognizing this, Commonwealth's Credit Policy Manual highlighted the importance of guarantor financial information to evaluating collectability, describing one characteristic of "problem loans" as a loan where "[t]he borrower or guarantor displays deterioration of financial condition as evidenced by financial statements or other available information."

15. Commonwealth's primary regulators – the SCC and the Federal Reserve Bank of Richmond (the "FRB") – had raised concerns that Commonwealth's lending and underwriting

⁵ In 2009, FASB codified existing standards into the Accounting Standards Codification (the "ASC"). The ASC is the current single source of United States Generally Accepted Accounting Principles ("GAAP"). During most of the time period relevant to this Order, the ASC had not yet been published; thus, the Order cites to pre-codification GAAP in effect at the time of the conduct discussed herein.

⁶ See, e.g., Commission Staff Accounting Bulletin No. 102, 66 Fed. Reg. 36,457, 36,462 n.44 (July 6, 2001).

practices were not keeping pace with the scope of loan growth. Specifically, the SCC's October 16, 2006 report of examination concluded that credit administration weaknesses existed, in part, due to numerous "[d]ocumentation exceptions" which "included missing or stale financial statements and/or income information along with the lack of final title policies, recorded deeds of trust, and cash flow analyses." The FRB's January 11, 2008 report of examination similarly concluded that "[a]n inordinate number of loans reviewed at this examination reflected lacking or stale financial information."

16. In September 2008, the SCC conducted an examination of Commonwealth that focused on capital adequacy, asset quality, management, earnings performance, liquidity and funds management, and sensitivity to market risk ("CAMELS"). As a result of that examination, the SCC downgraded the Bank's composite CAMELS rating to a 3 (indicating a financial institution with "a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe"). The SCC provided the Bank with a report of examination (the "2008 SCC Report") that deemed the institution to be in troubled condition and board and management performance to be poor. The 2008 SCC Report concluded that Commonwealth had experienced a significant deterioration in asset quality because "[t]he focus on loan growth overshadowed the need to properly observe effective credit-administration and underwriting practices." In particular, the 2008 SCC Report determined that "adversely classified assets" – loans that would have to be measured for impairment under FAS 114 – had, over the course of a year's time, increased from approximately \$8 million to \$80 million, a tenfold increase. According to the 2008 SCC Report, "[a] key contributing factor in the problems with the risk-identification system and the reserve methodology is the pervasive lack of current financial information on borrowers."

17. Despite the dire warnings in the 2008 SCC Report, Commonwealth failed adequately to address the concerns regarding the loan portfolio. As a result, in 2009, the FRB further downgraded the Bank's CAMELS score to a 5 (indicating a financial institution with "extremely unsafe and unsound practices or conditions . . . and are of the greatest supervisory concern").

18. Due in large part to Commonwealth's persistent failure to obtain and update appraisals and guarantor financial information, the FRB identified an understatement in Commonwealth's ALLL for the period ended September 30, 2009. On January 29, 2010, Commonwealth issued a press release disclosing \$23 million in additional ALLL for that period. The \$23 million ALLL increase caused Commonwealth to file amended and restated financials for the quarter ended September 30, 2009 with the Commission. Of the \$23 million increase, approximately \$10 million was attributable to downgrades of individual loans and loan relationships evaluated under the ASC's codification of FAS 114.⁷

19. After the restatement, Commonwealth's financial condition continued to deteriorate. On June 30, 2011, the FRB found that Commonwealth was "critically undercapitalized." On September 23, 2011, SCC and the FDIC, which insured the deposits held by

⁷ See generally ASC 310.

Commonwealth, closed the Bank and entered into a purchase and assumption agreement with a subsidiary of a privately held bank holding company to assume the deposits of the Bank.

E. The Auditors Recognized the Risks in Commonwealth's Troubled Loan Portfolio

20. Prior to and during Witt Mares' 2008 audit of Commonwealth, Poti was aware of the risk and significance of the Bank's ALLL, and of the component related to the Bank's FAS 114 loans specifically.

1. Poti Identified Risks During Witt Mares' 2006 and 2007 Audits

21. Poti served as the lead partner on the Commonwealth audit for the year-end 2006 through 2009 audits and had raised concerns regarding Commonwealth's loan portfolio to Commonwealth during earlier audits. On March 13, 2007 and March 10, 2008, Poti signed, on Witt Mares' behalf, reports to Commonwealth's audit committee. These reports commented on the lack of current financial statements and other loan documentation in Commonwealth's loan files and noted that "credit decisions made on outdated or inaccurate financial information can potentially lead to an increase in classified assets and losses for the Bank."

22. By the time that Witt Mares began its audit work for the year ended December 31, 2008, despite the repeated comments in reports to Commonwealth's audit committee described above in Paragraph 21, Commonwealth's management had not corrected the previously-identified deficiencies.

2. Poti Identified ALLL Risks During Witt Mares' 2008 Audit

23. The year-end 2008 audit planning document – which Poti reviewed and approved – identified the ALLL as a "High Risk Audit Area." A risk assessment summary work paper noted that the Bank's ALLL presented a significant risk of material misstatement, with respect to inherent risk and the risk of fraud.

3. The Initial Calculation of Commonwealth's ALLL Was Performed by A Senior Loan Officer

24. During Witt Mares' walk-through of Commonwealth's internal controls, a manager on the audit learned that the senior loan officer performed the initial ALLL calculation, which was then reviewed by, among others, the Bank's vice president for credit administration, Chief Financial Officer (the "CFO") and the Board of Directors. Poti, who reviewed the memorandum summarizing the manager's walkthrough of Commonwealth's ALLL controls, had significant concerns about having the senior loan officer perform the initial ALLL calculation since the loan officer was evaluating many loans that he originated and closed.

4. The SCC Identified a Significant Understatement of the ALLL

25. In connection with its September 2008 examination, the SCC identified a deficiency in Commonwealth's ALLL as of September 30, 2008 in the amount of \$19 million, representing an approximate 200% increase over the ALLL reported the previous year of

approximately \$9 million. Poti was aware of this deficiency: A manager had directly identified “the need for significant additions” to the ALLL in a work paper summarizing the 2008 SCC Report that Poti reviewed. Further, the 2008 SCC Report, discussed above in Paragraph 16, was provided to Witt Mares and included in the work papers.

5. Witt Mares’ Testing Identified A Significant Deficiency in Internal Control Over Financial Reporting in Commonwealth’s ALLL Process and Controls

26. The summary of the 2008 SCC Report, discussed above in Paragraph 25, also highlighted for Poti the following issues, among others: (a) The lack of current guarantor financial statements; (b) excessive financial statement exceptions; (c) inadequate cash flow analyses and loan review; (d) a significant deterioration in asset quality; and (e) a significant understatement of Commonwealth’s ALLL. The results of the SCC were a surprise to Poti, who remarked in an e-mail to a colleague that he felt that Commonwealth’s management had “mislead [sic] us about the severity of the State exam.”

27. Poti was sufficiently concerned by the SCC’s findings that he caused additional audit testing of Commonwealth’s internal controls to be conducted. The audit tests designed were:

a. Testing of controls designed to ensure that all nonaccrual loans were placed on the nonaccrual list;

b. Testing of controls designed to ensure that loan officers had obtained updated financial information for loans placed on the Bank’s watch list;

c. Testing of controls designed to confirm that the Bank’s loan officers were obtaining or performing current cash flow projections, appraisals or other analyses for loans placed on the Bank’s watch list;

d. Testing of controls designed to confirm that extensions of credit and renewed loans were being closed in a manner consistent with terms approved by the Board of Directors;

e. Testing of controls designed to determine the proper treatment of capitalized interest; and

f. Testing of controls designed to determine if critical items were being cleared in a timely fashion from the Bank’s exception reports and confirm that management was monitoring the reports.

28. Of the six specific tests described above in Paragraph 27, Witt Mares noted deviations from Commonwealth’s controls in all but one of the tests (described in Paragraph 27.a). Witt Mares noted deviations from Commonwealth’s controls for four of the tests (described in Paragraphs 27.b, 27.c, 27.d, and 27.e). Witt Mares’ work papers did not document the results of the sixth test (described in Paragraph 27.f). The results of the specific tests and led the Witt Mares audit team to conclude that a significant deficiency in internal control over financial reporting existed as of the year ended December 31, 2008.

6. The Audit's Substantive Testing of ALLL Identified Significant Problems

29. Through the audit team's work, Poti was aware that, despite market declines, Commonwealth management often did not get updated appraisals on the collateral underlying the Bank's FAS 114 loans or guarantor financial information for the guarantors of the loans. In fact, around the same time as the audit of Commonwealth was taking place, Poti understood that "appraisals as current as 6 months ago could be considered stale and not reflective of true market values." During the audit team's review of Commonwealth's loan portfolio as of year-end 2008, members of the audit team noted appraisals more than a year old and a significant lack of current guarantor financial information in loan files. In fact, during Witt Mares' review of Commonwealth's loan portfolio, the audit team noted that there was:

a. "Inadequate financial information in [the] file to determine if additional reserve is necessary" for loan files representing approximately 30% of the value of the total loan sample balance and approximately 5% of the value of the FAS 114 loans in the ALLL;

b. Approximately 75% of the value of the total loan sample balance and approximately 52% of the value of the FAS 114 loans in the ALLL represented loan files that were missing, or contained stale, guarantor financial information; and

c. Approximately 33% of the value of the total loan sample balance and approximately 37% of the value of the FAS 114 loans in the ALLL consisted of loan files that contained appraisals that were dated between 2005 and 2007 – dates more than a year before the loan review took place.

F. Commonwealth's FAS 114 Loans Were Material

30. The portion of the ALLL related to Commonwealth's FAS 114 loans was approximately \$21 million and was material.⁸ It far exceeded the approximately \$5 million planning materiality threshold established for the 2008 audit. It was reasonably possible that even a small change in the value of the Bank's FAS 114 loans would cause a material error in the financial statements.

31. The portion of the ALLL related to Commonwealth's FAS 114 loans was material for additional reasons:

a. The trend in Commonwealth's reported ALLL was in precipitous decline. As of December 31, 2006, Commonwealth's reported ALLL was slightly more than \$8 million. At year-end 2007, the ALLL slightly increased to approximately \$9 million. By year-end 2008, the ALLL had more than tripled to approximately \$31 million.

⁸ AU § 312 ¶ 3 ("The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important.") (footnote omitted).

b. On November 6, 2008, Commonwealth issued a press release announcing its third quarter results, which included disclosure of the \$19 million ALLL deficiency described above in Paragraph 25. The next trading day following this disclosure, the value of Commonwealth's common stock plummeted approximately 14%.

c. Commonwealth itself acknowledged the importance of its ALLL, including the FAS 114 loans, devoting several pages in its Form 10-K for the year ended December 31, 2008 (the "2008 10-K") to a discussion of problem loans and the ALLL. Indeed, Commonwealth's 2008 10-K expressly warned that "[if] our allowance for loan losses becomes inadequate, our results of operations may be adversely affected."

32. Given the risk and materiality of the ALLL related to the Bank's FAS 114 loans, and the many identified red flags described above in Paragraphs 21 through 29, Poti had heightened responsibility in auditing this area, and was required to obtain sufficient competent evidential matter to support his opinion. He failed in this responsibility.

G. Poti Caused Witt Mares to Issue an Unqualified Opinion

33. On March 16, 2009, Commonwealth filed audited consolidated financial statements as an exhibit to the 2008 10-K. Filed with the financial statements was Witt Mares' audit report dated March 11, 2009, which stated, among other things, that "[i]n our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Bankshares, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America[.]" and that "in our opinion, Commonwealth Bankshares, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008"

H. Poti's Improper Professional Conduct

34. The Commission's Rules allow the Commission to censure or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way certain professionals who violate "applicable professional standards."⁹ For auditors of issuers such as Commonwealth, the applicable professional standards include auditing standards issued by the PCAOB.

1. General Standards

35. The PCAOB's three general standards of auditing require that an auditor, among other things, exercise due professional care in the performance of the audit.¹⁰ The three basic standards of field work require the auditor to (1) adequately plan and properly supervise the audit,

⁹ Rule 102(e) [17 C.F.R. § 201.102(e)].

¹⁰ AU § 150 ¶ 2.

(2) obtain a sufficient understanding of internal control to plan the audit, and (3) obtain sufficient competent evidential matter to afford a reasonable basis for an opinion.¹¹

36. Auditors are required to obtain “sufficient competent evidential matter” to afford a reasonable basis for the auditor’s opinions.¹² “Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence.”¹³ PCAOB standards note that evidential matter obtained from independent sources outside an entity provides greater assurance of reliability than that secured solely within the entity, and that the auditor’s direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.¹⁴

37. Further, audit procedures, and the amount and persuasiveness of evidence auditors are required to obtain, are driven by risk. “Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.”¹⁵ When auditors identify a significant risk of material misstatement, as they did here, that fact is relevant to, among other things, the nature and extent of the audit procedures to be applied.¹⁶ “Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year-end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.”¹⁷

38. Poti, as the engagement partner, was responsible for the audit and its performance, for proper supervision of the work of the audit team members, and for compliance with PCAOB standards.

39. At the completion of the audit, Poti signed off that he had “reviewed the completed audit programs” and was “satisfied that our audit(s) of the financial statement and internal control”

¹¹ *Id.*

¹² AU § 326 ¶ 1; *see also* AU § 230 ¶ 11 (“The independent auditor’s objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion.”).

¹³ AU § 230 ¶ 8.

¹⁴ AU § 326 ¶ 21.

¹⁵ AU § 312 ¶ 1; *see also id.* ¶ 12 (“The auditor should consider audit risk and materiality both in (a) planning the audit and designing auditing procedures and (b) evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The auditor should consider audit risk and materiality in the first circumstance to obtain sufficient competent evidential matter on which to properly evaluate the financial statements in the second circumstance.”).

¹⁶ *Id.* ¶ 17.

¹⁷ *Id.*

were “sufficient and appropriate to support the auditor’s report(s) and were conducted in accordance with PCAOB standards and other applicable legal and regulatory requirements.”

40. As detailed below, Poti’s conduct in planning, supervising, and performing Witt Mares’ audit of Commonwealth’s 2008 internal control over financial reporting and financial statements – specifically the portions of the audit relating to the Bank’s FAS 114 loans – violated numerous PCAOB standards. Most prominently, the auditors violated the requirements of AS No. 5 (An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements), and AU Sections 328 (Auditing Fair Value Measurements and Disclosures) and 342 (Auditing Accounting Estimates) related to the substantive audit procedures. Poti also violated the third standard of field work (Audit Documentation).

2. The Audit of Commonwealth’s Internal Control over Financial Reporting Violated Professional Standards

41. For year-end 2008, Witt Mares performed an integrated audit of Commonwealth, meaning that the audit of Commonwealth’s internal controls over financial reporting was integrated with the audit of Commonwealth’s financial statements. When an auditor assesses control risk below the maximum level, as the auditors did here, he or she should obtain sufficient evidential matter to support that assessed level.¹⁸ Moreover, if one or more material weaknesses exist, the company’s internal control over financial reporting cannot be considered effective.¹⁹ “A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.”²⁰

42. AS No. 5 provides specific requirements for auditing internal control over financial reporting in an integrated audit, including that the auditors should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated and focus more of his or her attention on the areas of highest risk.²¹ As described below, the audit

¹⁸ AU § 319 ¶¶ 80, 90.

¹⁹ AS No. 5 ¶ 2.

²⁰ *Id.* App. A ¶ A7.

²¹ *Id.* ¶¶ 11 (“A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company’s internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company’s internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.”), 30 (“As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial

team, under Poti’s supervision, identified a source of potential misstatement in Commonwealth’s ALLL processes – the senior loan officer’s initial calculation of the ALLL. The audit team also identified a control that they believed addressed the potential for a material misstatement posed by the senior loan officer’s role in calculating the ALLL: the review by the Bank’s vice president for credit administration, CFO and the Board of Directors. However, the audit team failed to test this control despite being put on notice before the audit opinion was issued that it was not effective.²² Poti therefore violated AS No. 5, and further lacked a reasonable basis for causing Witt Mares to conclude that there were no material weaknesses in Commonwealth’s internal control over financial reporting.

a. Relevant PCAOB Standards

43. In an integrated audit, an auditor should design tests of controls to obtain sufficient evidence both to support his or her opinion on internal control over financial reporting and to support his or her control risk assessments for the purpose of the audit of the financial statements.²³

44. Auditors also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. One of the ways to do so is “by asking himself or herself ‘what could go wrong?’ within a given significant account or disclosure.”²⁴

45. To further understand the likely sources of potential misstatements, and as part of selecting the controls to test, the auditor should, among other things, understand the flow of transactions related to the relevant assertions, identify the points within the company’s processes at which a misstatement could arise that would be material, and identify the controls that management has implemented to address these potential misstatements.²⁵

46. Performing a “walkthrough” is often the most effective way to understand likely sources of potential misstatements and identify the appropriate controls to test.²⁶ Walkthroughs require the auditor to “follow[] a transaction from origination through the company’s processes . . .

statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself ‘what could go wrong?’ within a given significant account or disclosure.”).

²² See *id.* ¶ 39 (“The auditor should test those controls that are important to the auditor’s conclusion about whether the company’s controls sufficiently address the assessed risk of misstatement to each relevant assertion.”).

²³ *Id.* ¶ 7.

²⁴ *Id.* ¶ 30.

²⁵ *Id.* ¶ 34.

²⁶ *Id.* ¶ 37.

until it is reflected in the company's financial records, using the same documents and information technology that company personnel use."²⁷

47. The selection of the controls to test, and the evidence needed to evaluate a given control, are driven by the auditor's risk assessment.²⁸ "The auditor should focus more of his or her attention on the areas of highest risk," taking into consideration risks of material misstatement due to fraud with respect to significant management estimates.²⁹ Further, the level of evidence needed increases as the risk associated with the control increases.³⁰

48. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests.³¹ PCAOB standards include a hierarchy of tests. Inquiry, which ordinarily produces the lowest level of evidence, is never alone sufficient to support a conclusion about the effectiveness of a control.³²

49. If there are deficiencies in a company's internal control over financial reporting that, individually or in combination, result in one or more material weaknesses, the auditor "must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement."³³

50. The internal control test work that Poti supervised did not comply with the foregoing PCAOB standards.

b. Failure to Identify Effective Controls Over The Review of the ALLL Calculation

51. In order to understand the likely sources of a potential misstatement of the ALLL, a manager, under Poti's supervision, performed a walkthrough of Commonwealth's internal controls over the ALLL. As described above in Paragraph 24, the manager documented his walkthrough in audit work papers that Poti reviewed and identified the senior loan officer's initial calculation of the ALLL as a point in the ALLL processes at which a material misstatement could arise. The manager also identified a control that he believed addressed the potential for a material misstatement posed by the senior loan officer's role in calculating the ALLL: the review by the

²⁷ *Id.*

²⁸ *Id.* ¶ 10.

²⁹ *Id.* ¶¶ 11, 14.

³⁰ *Id.* ¶¶ 46-47.

³¹ *Id.* ¶ 50.

³² *Id.* ¶¶ 45, 50.

³³ *Id.* ¶ 90.

Bank's vice president for credit administration, CFO and the Board of Directors. The manager observed that the processes for calculating Commonwealth's ALLL did not constitute "a significant deficiency due to the review performed by the CFO, and that [the] VP of Credit Administration is heavily involved in the discussions of impaired loans though he does not actually do the manual calculation. Board and Management both review and approve [the] calculation." In fact, the audit team assessed the ALLL's control risk to be "moderate" based on "relatively strong controls and procedures over the allowance" and identified the review by the Bank's vice president for credit administration, CFO and Board of Directors as one of four key controls over the ALLL.

52. The audit work papers do not reflect that any testing of the design or operating effectiveness of the CFO's, the vice president of credit administration's, or the Board of Directors' review of the ALLL was performed. Moreover, other than an assertion that such a review was done, the audit work papers do not describe what the CFO, vice president of credit administration, or the Board of Directors were required to do or what they actually did to review the ALLL. Poti did not know what steps the CFO, the vice president of credit administration, or the Board of Directors took to review the senior loan officer's calculation of the ALLL. In fact, the only evidence of review in the audit work papers was a review of the minutes of Commonwealth's Board of Directors to confirm that the minutes reflected the Board's approval of the ALLL. Thus, though the audit team correctly identified the senior loan officer's initial calculation of the ALLL as creating a potential risk for material misstatement, the audit work does not provide a basis to conclude that it did not represent a material weakness.

53. In fact, before Poti authorized the issuance of an unqualified audit opinion on Commonwealth's financial statements and internal control over financial reporting for the year ended December 31, 2008, Commonwealth's internal auditor wrote to Poti that, based on the internal auditor's testing of the control designed to ensure that the vice president of credit administration had adequate information to review the ALLL, the internal auditor had determined that the review control was not working properly as of year-end 2008 because, among other things, the vice president of credit administration had not received information from loan officers to independently assess if loans had become impaired.

c. The Absence of These Controls Was an Indicator of a Material Weakness in Commonwealth's Internal Control Over Financial Reporting

54. PCAOB audit standards define a material weakness as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."³⁴ Whether a deficiency or combination of deficiencies rises to the level of a material weakness depends on the severity of the deficiencies.³⁵ The absence of effective controls over the review of the ALLL calculation should

³⁴ *Id.* App. A ¶ A7.

³⁵ *Id.* ¶¶ 62-63.

have been treated as an indicator of a material weakness in Commonwealth's internal control over financial reporting as of December 31, 2008.³⁶ Had Poti tested the control over the review of the ALLL calculation, he would have learned that it was not effective since one of the key components of the control – the review by the vice president for credit administration – was not working properly because the vice president for credit administration did not have current guarantor financial information to independently assess if loans had become impaired. Without having tested this important control over the ALLL, and having information, including from internal audit, indicating that it was deficient, Poti did not have a sufficient basis to conclude that no material weaknesses existed and to issue an unqualified opinion on the Bank's internal control over financial reporting.³⁷ Moreover, the inappropriate conclusion that controls were effective led to an unsupported – and incorrect conclusion that, for purposes of the financial statement audit, the risk of material misstatement with respect to the ALLL was only “moderate.”

3. Substantive Testing of Commonwealth's FAS 114 Loans Violated Professional Standards

55. Adding to the failures in connection with auditing Commonwealth's internal control over financial reporting were Poti's deficient substantive audit procedures. Specifically, the audit team failed to follow PCAOB standards in reviewing the reasonableness of management's estimates of impairment of the Bank's FAS 114 loans – one of the riskiest and most critical elements of the Bank's FAS 114 loss estimate calculation. The audit team found that, in estimating the ALLL, Commonwealth relied on the appraisals in the loan files, many of which were dated between 2005 and 2007 – over a year before the loan review took place. Poti was aware of the significance of the dates of the appraisals because of his understanding that “appraisals as current as 6 months ago could be considered stale and not reflective of true market values.” In addition, the audit team found that, for approximately 30% of the total loan sample balance the team felt that there was “[i]nadequate financial information in [the loan] file to determine if additional reserve is necessary.” Poti reviewed the audit team's FAS 114 test work prior to signing the audit opinion. By failing to subject the ALLL to appropriate scrutiny, Poti violated PCAOB standards, including AU Sections 328 and 342, which address auditing fair value and accounting estimates, respectively. Poti failed to obtain sufficient competent evidential matter to support management's estimate of the ALLL.

a. Relevant PCAOB Standards

56. Commonwealth's calculation of the portion of the ALLL attributable to the Bank's FAS 114 loans, which was based largely on an assessment of the value of the underlying collateral, was an estimate. As such, the auditor's responsibility was to obtain sufficient competent evidence to provide reasonable assurance that the estimates were reasonable and presented in conformity with the relevant accounting principles.³⁸

³⁶ *Id.* ¶¶ 69-70.

³⁷ *Id.* ¶ 71.

³⁸ AU §§ 328 ¶ 3; 342 ¶ 7.

57. In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches: (a) review and test the process used by management to develop the estimate; (2) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate; or (3) review subsequent events or transactions occurring prior to the date of the auditor's report.³⁹

58. Where management's estimate is based on a valuation, such as an appraisal, that was made prior to the financial reporting date, the following is an example of a consideration in the development of audit procedures: "obtain[ing] evidence that management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date of the fair value measurement and the reporting date."⁴⁰

59. Further, as Poti had correctly identified Commonwealth's ALLL as presenting a risk of fraud and a higher risk of error, Poti had a heightened responsibility over this area.⁴¹

60. The risk of material misstatement generally increases where, as here, the relevant account includes an estimate.⁴² While estimates may differ, an unreasonable estimate should be considered a likely misstatement.⁴³

61. The auditor should be thorough in his or her search for evidential matter and unbiased in its evaluation.⁴⁴ The auditor cannot express the conclusion in the auditor's standard report that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles without obtaining sufficient competent evidential matter to support that conclusion.⁴⁵

³⁹ AU § 342 ¶ 10; *see also* AU § 328 ¶ 23.

⁴⁰ AU § 328 ¶ 25.

⁴¹ AU § 312 ¶ 17 ("Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year-end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.").

⁴² *Id.* ¶ 36.

⁴³ *Id.*

⁴⁴ AU § 326 ¶ 25; *see also id.* ("In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.").

⁴⁵ *See* AU § 508 ¶ 7 ("The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be

62. Finally, auditors are required to clearly document the work they perform.⁴⁶ “Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached.”⁴⁷ “The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions.”⁴⁸ “Audit documentation must clearly demonstrate that the work was in fact performed.”⁴⁹ “Because audit documentation is the written record that provides the support for the representations in the auditor’s report, it should,” among other things, “[d]emonstrate that the engagement complied with the standards of the PCAOB.”⁵⁰

63. The substantive audit procedures Poti designed and implemented fell short of these standards.

b. Failure to Obtain Sufficient Audit Evidence

64. Commonwealth estimated the value of the collateral underlying the Bank’s FAS 114 loans on a loan-by-loan basis because the Bank’s FAS 114 portfolio was made up of large, non-homogenous loans. Therefore, the audit team performed a loan-by-loan review of a sample of the Bank’s FAS 114 loan portfolio to test whether management’s estimates of value were reasonable. However, the substantive audit procedures and the evidence obtained from those procedures were insufficient to meet PCAOB standards.

65. As part of Witt Mares’ testing of Commonwealth’s FAS 114 loans, the audit team selected a sample of Commonwealth’s loan portfolio for in-depth review that represented approximately 14% of the total loan balance, and approximately 55% of the ALLL, at year-end 2008. After selecting the sample of loans to review, the audit team examined the loan file documentation, estimated the specific allowance or allocation needed for each loan, and assessed the reasonableness of management’s estimate of the ALLL comparing the estimated ALLL to the recorded ALLL. However, as documented in the audit work paper, for a significant portion of the loans reviewed, there was inadequate information to perform this assessment.

66. Witt Mares’ 2008 loan review found that approximately 30% of the total loan sample balance and approximately 5% of the ALLL, respectively, had “[i]nadequate financial information in [the loan] file to determine if additional reserve is necessary;” approximately 75%

expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.”).

⁴⁶ See AS No. 3.

⁴⁷ *Id.* ¶ 4.

⁴⁸ *Id.* ¶ 6.

⁴⁹ *Id.*

⁵⁰ *Id.* ¶ 5.

of the total loan sample balance and 52% of the ALLL consisted of loans whose files were missing, or contained stale, guarantor financial information; and approximately 33% of the total loan sample balance and approximately 37% of the ALLL consisted of loans whose files contained appraisals that were dated between 2005 and 2007 – dates more than a year before the loan review took place. In short, the files lacked critical information necessary to assess the FAS 114 loans and their reserves.

67. Despite the critical lack of information needed to assess the reasonableness of management’s loss estimates on the FAS 114 loans, Witt Mares auditors agreed with management’s loss estimates for all of the loans in the loan sample except one and concluded that “the Bank appears to have enough reserved to sustain any immediate short term losses.” That conclusion was not supported by the available audit evidence. To the contrary, the audit evidence would lead a reasonable auditor to the opposite conclusion – that the ALLL was not a reasonable estimate because there was not sufficient information in the loan files to evaluate its reasonableness.

c. Failure to Adequately Document Audit Work

68. In addition to the audit failures noted above, Poti failed to adequately document audit work.⁵¹ Witt Mares’ loan work papers do not contain any explanation as to how the audit team evaluated whether management took into account the effect of deteriorating market conditions that had occurred between the appraisal dates for the approximately 33% of the total loan sample balance and approximately 37% of the ALLL that consisted of loans whose files contained appraisals that were dated between 2005 and 2007 – dates more than a year before the loan review took place. In addition, the work papers do not explain how Witt Mares was able to develop an independent estimate of the ALLL given that approximately 30% of the total loan sample balance and approximately 5% of the ALLL, respectively, had “[i]nadequate financial information in [the loan] file to determine if additional reserve is necessary.”

D. FINDINGS

69. Based on the foregoing, the Commission finds that Poti engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission’s Rules of Practice [17 C.F.R. § 201.102(e)(1)(ii)].⁵² Specifically, the Commission finds that Poti engaged in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

⁵¹ *Id.*

⁵² *See also* Rule 102(e)(1)(iv)(B)(2) (defining improper professional conduct) [17 C.F.R. § 201.102(e)(1)(iv)(B)(2)].

IV.

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

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

A. Poti is denied the privilege of appearing or practicing before the Commission as an accountant.

B. After two (2) years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

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

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

(a) Respondent, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

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

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

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

D. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary