INITIAL DECISION RELEASE NO. 411
ADMINISTRATIVE PROCEEDING
FILE NO. 3-13797

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

In the Matter of	:	
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GERARD A.M. OPRINS, CPA, and	:	INITIAL DECISION
WENDY McNEELEY, CPA	:	December 28, 2010

APPEARANCES: Andrea R. Wood, Robert M. Moye, and Christopher S. Shearer, for the Division of Enforcement, Securities and Exchange Commission.

Julie A. Smith, Gregory S. Bruch, and Jessica L. Matelis of Willkie Farr & Gallagher LLP, for Respondent Gerard A.M. Oprins, CPA.

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

BEFORE: Robert G. Mahony, Administrative Law Judge

I. INTRODUCTION

The Securities and Exchange Commission (SEC or Commission) issued a Corrected Order Instituting Proceedings (OIP) on March 1, 2010, against Gerard A.M. Oprins, CPA (Oprins) and Wendy McNeeley, CPA (McNeeley) (collectively, Respondents), pursuant to Section 4C of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78d-3, and Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e) (Rule 102(e)).[1]

The OIP alleges that Oprins and McNeeley, as the engagement partner and manager, respectively, for the global accounting firm Ernst & Young LLP (E&Y), engaged in improper professional conduct under Rule 102(e) during their audit of AA Capital Partners, Inc. (AA Capital), and AA Capital Equity Fund, L.P. (Equity Fund), for the year ended December 31, 2004 (2004 Audit). The OIP alleges that Respondents (i) failed to conduct the 2004 Audit in

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[1] Section 4C of the Exchange Act codifies Rule 102(e) of the Commission's Rules of Practice. References to Rule 102(e) include Section 4C of the Exchange Act.

accordance with generally accepted auditing standards (GAAS)[2] and (ii) caused E&Y to issue unqualified audit reports for AA Capital's and the Equity Fund's 2004 financial statements that included specific disclosures not in conformity with generally accepted accounting principles (GAAP).[3] Specifically, it alleges that Respondents failed to obtain sufficient competent evidential matter and exercise due professional care with respect to their evaluation and disclosure of a $1.92 million related-party "tax loan" to John Orecchio (Orecchio), co-owner of AA Capital. Rather, the OIP alleges that Respondents relied solely on doubtful and unsubstantiated information obtained from Mary Beth Stevens (Stevens), AA Capital's chief financial officer. The OIP further alleges that Oprins violated GAAS by failing to properly supervise the 2004 Audit.

The OIP alleges that Respondents engaged in intentional or knowing conduct, including reckless conduct, that resulted in a violation of applicable professional standards, or in the alternative, negligent conduct, consisting of a single instance of highly unreasonable conduct in circumstances in which Respondents knew, or should have known, that heightened scrutiny was warranted. 17 C.F.R. § 201.102(e)(1)(iv)(A), (B)(1). The Division of Enforcement (Division) urges that Oprins and McNeeley be denied the privilege of appearing or practicing before the Commission as accountants for a period of three years.

A hearing was held in Chicago, Illinois, on July 26-30 and August 2-4, 2010. The Division called seven witnesses, including Respondents and an expert witness. Respondents called three witnesses, including two experts. Numerous exhibits were admitted into evidence.[4]

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[2] GAAS are a set of standards of conduct relating to how auditors should perform an audit. See SEC v. Arthur Young & Co., 590 F.2d 785, 788 n.2, 789 n.4 (9th Cir. 1979). GAAS are comprised of ten general standards and further defined or interpreted by Statements on Auditing Standards (SAS), which are published by the American Institute of Certified Public Accountants (AICPA) and codified by topic in the Codification of Statements on Auditing Standards, as "AU § ___." (Div. Ex. 98 at 3.)

[3] GAAP are guidelines, established by the Financial Accounting Standards Board and other accounting industry authorities, used to measure economic activity and present them in the form of financial statements and related disclosures. Arthur Young, 590 F.2d at 789 n.4. AA Capital's financial statement was prepared on a tax basis, which is a "comprehensive basis of accounting" other than GAAP; however, the audit procedures performed under GAAS and the related-party disclosure requirements under GAAP are the same for financial statements presented in conformity with GAAP or on a tax basis. (Tr. 176-78.)

[4] Citations to the transcript of the hearing are noted as "(Tr. ___.)". Citations to the parties' joint stipulations will be noted as "(Stip. ___.)". Citations to Oprins' and McNeeley's answers are noted as "(Oprins Answer ___.)" and "(McNeeley Answer ___.)," respectively. Citations to exhibits offered by the Division and Respondents are noted as "(Div. Ex. ___.)" and "(Resp. Ex. ___.)," respectively. The Division's posthearing brief is noted as "(Div. Br. ___.)," and Respondents' posthearing briefs are noted as "(Oprins Br. ___.)" and "(McNeeley Br. ___.)". The Division's reply to Respondents' posthearing briefs is noted as "(Div. Reply Br. ___.)" and Respondents' replies to Division's posthearing brief are noted as "(Oprins Reply Br. ___.)," and "(McNeeley Reply Br. ___.)".

The Division and Respondents filed Proposed Findings of Fact and Conclusions of Law and supporting briefs.

In their posthearing briefs, Oprins and McNeeley contend that the audit team complied with GAAS in gathering sufficient evidential matter concerning the "tax advance." (Oprins Br. 17-22; Oprins Reply Br. 11; McNeeley Br. 3-6; McNeeley Reply Br. 3-17.) Respondents assert that they properly opined that AA Capital's and the Equity Fund's financial statements complied with GAAP, and that sanctions against them would not serve the public interest. (Oprins Br. 22-23, 34-35; Oprins Reply Br. 11-13, 17-18; McNeeley Br. 26-35; McNeeley Reply Br. 17-22.) Respondents further argue that the audit team did not act recklessly or in a highly unreasonable manner in circumstances warranting heightened scrutiny. (Oprins Br. 28-33; Oprins Reply Br. 6-8; McNeeley Br. 35-39; McNeeley Reply Br. 23-29.) Oprins and McNeeley ask that the proceeding against them be dismissed and that no sanctions be imposed against them, respectively. (Oprins Br. 36; Oprins Reply Br. 18; McNeeley Br. 40, 45-46; McNeeley Reply Br. 37.)

II. FINDINGS OF FACT

The findings and conclusions herein are based on the hearing record. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91 (1981). All arguments, proposed findings, and conclusions set forth by the parties were considered and only those consistent with this Initial Decision are accepted.

A. Background

1. AA Capital and the Equity Fund

AA Capital, headquartered in Chicago, Illinois, is registered with the Commission as an investment adviser under the Investment Advisers Act of 1940. (Stip. 1, 2.) AA Capital was co-owned by Orecchio and Paul Oliver, Jr. (Oliver). (Div. Ex. 98 at 2.) Orecchio, a former managing director at Bank of America, owned a fifty percent interest in AA Capital and served as a director, president, and secretary. (Tr. 21, 1096, 1763; Div. Ex. 98 at 2; Stip. 9.) Orecchio exercised day-to-day management and control over the affairs of AA Capital. (Tr. 1460; Resp. Ex. 431A at 77.) Oliver, a former chief financial officer at ABN-AMRO, owned the other fifty percent interest in AA Capital and served as its chairman and treasurer. (Tr. 1096, 1763, 1767; Div. Ex. 98 at 2.) Stevens, who had prior financial services experience at Bank of America, served as the chief financial officer and chief compliance officer of AA Capital. (Tr. 50, 168, 1763; Div. Ex. 98 at 2; Stip. 10.) During the 2004 Audit, Stevens was responsible for the entire accounting function. (Tr. 185.)

AA Capital created several private equity funds (Funds), each formed as a limited partnership, into which AA Capital placed investors. (Stip. 5.) AA Capital invested client money in four affiliated Funds, the largest of which was the Equity Fund. (Stip. 5, 6.) As of December 31, 2004, the Equity Fund had approximately $131 million in assets under management. (Stip. 7.) Orecchio and Oliver each owned approximately twenty percent of AA

Private Equity Investors Management, LLC, the general partner of the Equity Fund. (Div. Ex. 98 at 2.)

During 2004, the Equity Fund's limited partners were three pension fund clients[5] whose rights and obligations, along with those of the general partner, were set forth in a limited partnership agreement (Partnership Agreement). (Tr. 108-110; Div. Ex. 98 at 2; Resp. Ex. 431A at 7.) Each investor in the Funds deposited the total amount of its investment commitment with AA Capital, which placed the deposits in separate bank trust accounts (Investor Trust Accounts) in the name of each investor, until AA Capital, in its discretion, made a capital call. (Div. Ex. 98 at 2; Stip. 8.) Pursuant to its governing documents, a Fund could call capital from the Investor Trust Accounts for three primary purposes, to: (i) make investments; (ii) pay management fees; or (iii) pay overhead expenses. (Div. Ex. 243 at 4-5.) E&Y conducted the audits of AA Capital's and its affiliated Funds' financial statements, and provided related tax services, for the fiscal years 2002 through 2005.[6] (Stip. 18, 19.)

2. Gerard A.M. Oprins

Oprins, age 51, is a resident of Glen Ellyn, Illinois. (Tr. 473; Oprins Answer at 3.) Oprins graduated from Northern Illinois University in 1982 with a bachelor's degree in accounting and minor in mathematics. (Tr. 473-74.) He is a licensed certified public accountant (CPA), having worked at E&Y for almost 27 years, making partner in 1995. (Tr. 474-76; Oprins Answer at 3; Stip. 28-29.) During his career at E&Y, he served as the engagement partner on hundreds of audits. (Tr. 476.) Oprins left E&Y in April 2009 and is currently self-employed, providing consulting services in the area of asset management. (Tr. 474-75; Stip. 30.) During his career, Oprins was never previously subject to disciplinary action. (Tr. 29.)

3. Wendy McNeeley

McNeeley, age 34, resides in Monee, Illinois. (Tr. 138; McNeeley Answer at 4.) McNeeley graduated *magna cum laude* from Loyola University with a bachelor's degree in business administration. (Tr. 138, 353.) She is a licensed CPA, having taken and passed the CPA examination in November, 1998. (Tr. 138; McNeeley Answer at 4.) Upon graduation, McNeeley began working as a staff auditor for McGladrey & Pullen (McGladrey), a national accounting firm. (Tr. 139.) McNeeley later left McGladrey and joined E&Y as an audit manager in its financial services group. (Tr. 139-41; Stip. 26.) She left E&Y in July 2006 and took a position as a client services specialist at Spectrum Global Administration (Spectrum), a hedge fund administrator. (Tr. 140-41.) In February 2007, McNeeley left Spectrum and returned to McGladrey as a director in their financial services group, which is her current position. (Tr. 142, 359; Stip. 27.) In this capacity, McNeeley performs technical reviews on

[5] The clients were the Carpenters' Pension Trust Fund, Operating Engineers Local No. 324 Pension Fund, and the Michigan Teamsters Joint Council No. 43 Pension Fund. (Tr. 108, 1358-59; Resp. Ex. 431B at 4; Stip. 4.)

[6] E&Y did not issue its 2005 audit reports for AA Capital or the affiliated funds. (Tr. 524-526.)

financial statements of financial services clients.[7] (Tr. 142, 359.) During her career, McNeeley received strong performance reviews and never previously faced disciplinary action. (Tr. 361-62.)

B. The 2003 and 2004 Audits

1. Engagement Acceptance

Oprins' first involvement with AA Capital was in August 2004, after he returned from working for two-and-one-half years in E&Y's Luxembourg office. (Tr. 499, 547-48, 1794.) He received a phone call from Chuck Wall (Wall), the managing director at AA Capital and a personal friend to one of Oprins' partners at E&Y. (Tr. 499, 546-47, 1794.) Wall expressed his dissatisfaction with E&Y because the 2002 financial statements and audit reports were not completed on time. As a result, Wall and his partners at AA Capital were assessed substantial penalties and interest by the Internal Revenue Service (IRS). (Tr. 499, 546-47.) In response, Oprins followed up on Wall's complaints. (Tr. 547-49.)

Although AA Capital was a client of E&Y since 2002, Oprins performed due diligence in August 2004 to determine if E&Y should continue its relationship with AA Capital. (Tr. 552; Stip. 18-19.) Oprins spoke with six E&Y professionals in order to gather information about AA Capital, Orecchio, and Oliver. He also spoke with the E&Y tax group, including Tony Rentz (Rentz) and Marcel Haas (Haas). (Tr. 549-58.) Rentz was the head of E&Y's asset management tax practice, and Haas was the senior manager responsible for the AA Capital tax accounts. (Tr. 550.) Oprins' research indicated that AA Capital was a legitimate, respectable client. (Tr. 553-57.)

In March 2005, E&Y was engaged to audit and report on the financial statements of AA Capital for the years ended December 31, 2003 and 2004. (Stip. 20; Tr. 146-48; Div. Ex. 59.) The on-site work at AA Capital for the 2004 Audit occurred primarily in May and June 2005. (Stip. 24.) The engagement also included auditing private equity funds managed by AA Capital in 2003 and 2004. (Div. Ex. 59 at App. A; Tr. 145-51.) In sum, E&Y was engaged to simultaneously perform ten audits and issue final audit reports by June 30, 2005.[8] (Id.) The 2003 and 2004 audits were performed back-to-back because of delays in determining whether E&Y was going to continue its relationship with AA Capital.[9] (Tr. 478.) However, E&Y did not question management's integrity. (Tr. 551-53.)

[7] McNeeley's responsibilities also include reviewing filings for SEC clients, preparing case studies for in-house continuing professional education, and serving as a subject matter expert in fair valuing financial instruments. (Tr. 359.)
[8] The June 30, 2005, deadline was requested by AA Capital in order to provide investors with financial statements required to complete their tax filings. (Tr. 151, 161.)
[9] E&Y's concern was based on the fact that AA Capital was one of its "smallest" clients and it was difficult to staff an engagement of this size. (Tr. 478-79, 550.)

2. Audit Planning

Oprins was the engagement partner. (Stip. 21.) His role was to set the tone for the audit, staff the audit team adequately, and focus on high-risk areas. (Tr. 476.) His responsibility was to oversee the audit manager and sign the audit report(s). (Id.) As engagement partner, Oprins used discretion in reviewing the detailed audit workpapers, but typically reviewed workpapers that involved planning and audit strategy, as well as the GAAP Disclosure Checklist.[10] (Tr. 477.)

McNeeley was the audit manager. (Stip. 22.) She was responsible for day-to-day oversight of audit planning and execution of the audit strategy. (Tr. 143.) She also supervised the audit staff and reviewed audit workpapers in significant risk areas. (Tr. 143-44.) The audit team included an independent review partner, John Kavanaugh (Kavanaugh), two audit seniors, Andrew Palko (Palko) and Amanda Apau (Apau), and two audit staff, Aimee Moore and Corina Rojas (Rojas). (Stip. 23; Tr. 151-52.) Kavanaugh provided quality control. (Tr. 731, 759.) This required him to read the financial statements, to understand the audit approach, and to ensure that the financial statements were stated in accordance with GAAP or any other basis of presentation used. (Tr. 731-32.) Ultimately, Kavanaugh concurred with the audit opinion issued. (Tr. 765.)

The audit team held an initial planning meeting during which it addressed matters such as background information on the audit client and the industry in which it operates, associated business risks, the scope of the engagement, staffing, and other engagement logistics. (Tr. 171-72.) A client meeting took place on April 20, 2005, and included Oprins, McNeeley, Orecchio, and Stevens; topics of conversation included the upcoming audit, accounting issues, and inquiries into management's monitoring of fraud. (Tr. 571.)

The contact person for the 2003 and 2004 audits was Stevens. (Tr. 171.) McNeeley was new to the AA Capital account. (Tr. 146, 364.) In preparation for the audits, she reviewed the 2002 audit workpapers and financial statements.[11] (Tr. 364.) She made inquiries of Oprins to obtain an understanding of the basic client structure, the nature of the entity, and its industry. (Id.) McNeeley also gained an understanding of Oliver's role within the AA Capital organization. (Tr. 367.) She understood that as treasurer and co-owner with Orecchio, Oliver had a fiduciary duty to be fully knowledgeable regarding the transactions and business activities of AA Capital. (Id.)

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[10] The GAAP Disclosure Checklist was used by E&Y as a guide in preparing and reviewing financial statement disclosures. (Tr. 321-22, 477, 512; Div. Ex. 30.)

[11] In May 2005, McNeeley identified an accounting error in the 2002 audits of certain AA Capital related funds. (Tr. 185, 569-70; Resp. Ex. 6.) Her memorandum described the error as improper accounting for the cost and fair market value of certain investments made by the Equity Fund, AA Capital GKM Special Purpose Fund LP, and AA Capital Direct Investments Fund LP in 2002. (Resp. Ex. 6.) The memo concluded that the errors, which were material, should be corrected by adjusting the beginning balances of the affected accounts in the 2003 financial statements, with corresponding footnote disclosure. (Resp. Ex. 6.)

The planning and audit strategy was documented in an audit strategies memorandum (ASM). (Tr. 172-73; Div. Ex. 24.) The planning process evolved throughout the audit and included risk assessments. (Tr. 173.) As part of the assessments, the audit team determined not to rely on AA Capital's internal controls; instead, they performed substantive testing on all account balances.[12] (Tr. 178-79; Div. Ex. 24 at EY04000302.) It was typical for an auditor not to rely on controls for a private equity fund client. (Tr. 385, 578-79.) As part of the planning process, the audit team used a planning tool entitled Internal Control and Fraud Considerations (ICFC). (Tr. 188; Div. Ex. 25.) The ICFC assisted the audit team in identifying potential risks of material misstatement due to fraud. (Div. Ex. 25.)

3. General Audit Procedures

As the audit partner, Oprins' responsibility during the 2003 and 2004 audits was to review and analyze significant auditing issues brought to his attention by McNeeley or the audit team. (Tr. 573-74.) He did not participate in onsite audit fieldwork or review each audit workpaper included in the audit files. (Tr. 573.) Oprins was never specifically made aware of any issue pertaining to the purported "tax advance" to Orecchio. (Tr. 502-03, 581-82.)

The majority of work for the ten audits focused on investments, partners' capital, and management and incentive fees. (Tr. 397-99.) In auditing investments, the team reviewed subscription documents, vouched[13] cash disbursements and receipts for sales, and confirmed the existence and fair value of the investments. (Tr. 399-400.) To audit partners' capital, they obtained and tested the accuracy of a schedule detailing all inflows and outflows, vouched new contributions to bank statements and subscription documents, and confirmed with third parties the partners' capital balances at year end. (Tr. 400.) The audit team recalculated management fees in accordance with the management agreements, and for other expenses, vouched to invoices and bank statements. (Tr. 401.)

4. The 2004 Audit and $1.92 Million Transfer to Orecchio

During 2004, four cash transfers were made to Orecchio totaling approximately $1.92 million (collectively, the Transfers[14]). (Tr. 202-03; Stip. 11.) The funds were withdrawn from AA Capital's Investor Trust Accounts. (Stip. 12.) Orecchio claimed the Transfers were to pay a personal tax liability relating to AA Capital and its affiliated Funds. (Stip. 11.)

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[12] An auditor may test internal controls from which account balances are generated, and, if the controls are operating effectively, the auditor may deem the account balances correct. If the auditor decides not to rely on such controls, he may perform substantive auditing procedures on the ending account balances. (Tr. 179.)

[13] Vouching is a substantive testing technique that involves tracing the transaction to supporting documentation. (Tr. 181.)

[14] The Transfers have been referred to in testimony as a "tax loan," "tax advance," and "tax distribution." (Tr. 305.) In testimony, McNeeley referred to the Transfers as a "tax advance," but noted no difference between that term and "tax loan." (Tr. 202.) McNeeley also testified that references to "tax distribution" in the Receivable Schedule, discussed <u>infra</u>, were part of the same $1.92 million "tax loan." (Tr. 236.)

The Transfers were described in a client-prepared accounts receivable schedule (Receivable Schedule) as tax payments or tax distributions to Orecchio. (Tr. 204-05; Div. Ex. 67 at EY04000553-555.) McNeeley learned of the Transfers from one of the audit seniors who showed her the Receivable Schedule. (Tr. 204-05, 220-21.) She understood that the Transfers were related-party transactions. (Tr. 266-70.) The Transfers were reported in the financial statements as loans made by AA Capital and as borrowings by AA Capital from the Equity Fund. (Tr. 268-69; Div. Ex. 98 at 2.) Orecchio spent the $1.92 million, but did not use the funds to pay any tax liability. (Stip. 15.)

The Transfers were disbursed as follows:

- On May 19, 2004, $987,000 was transferred from two Investor Trust Accounts to AA Capital's primary bank account; the same day, $602,150 was transferred from AA Capital's primary bank account to Orecchio's personal bank account.

- On August 2, 2004, $190,000 was transferred from three Investor Trust Accounts to AA Capital's primary bank account; the same day, $190,154 was transferred from AA Capital's primary bank account to Orecchio's personal bank account.

- On September 20, 2004, $600,000 was transferred from three Investor Trust Accounts to AA Capital's primary bank account; the same day, $579,000 was transferred from AA Capital's primary bank account to Orecchio's personal bank account.

- On November 5, 2004, $550,000 was transferred from three Investor Trust Accounts to the Equity Fund's bank account; the same day, $550,000 was transferred from the Equity Fund's bank account to Orecchio's personal bank account.[15]

(Stip. 14.)

5. Audit Procedures Performed on the Transfers

On May 7, 2005, Rojas documented her understanding of the Transfers on the Receivable Schedule, stating:

> Per conversation w/ Mary Beth Stevens, CFO, all of the funds held under AA Capital Inc. had not finalized their audits, tax filings, and therefore John Orrechio [sic], (managing member) did not have a final tax return draft that included taxable income w/ set figures. Therefore he had to estimate his tax liability [and] made a payment to the IRS for 1,921,150. See N2.1. The 1,921,150 is essentially a loan made to John Orrechio [sic]. Mary Beth Stevens expects to receive payment from either Mr. Orrechio [sic] or the IRS after taxes are finalized.

[15] An e-mail dated June 16, 2005, from Stevens to McNeeley, details the Transfers in slightly different amounts: $596,129 (May 19, 2004); $188,100 (August 2, 2004); $573,210 (September 20, 2004); and $544,500 (November 5, 2004). (Resp. Ex. 131.)

(Tr. 230-31, 239-40; Div. Ex. 67 at EY04000555.) Rojas also identified $18,228 on the Receivable Schedule as a tax advance received by Oliver. (Tr. 241; Div. Ex. 67 at EY04000555.) The audit team vouched the Transfers identified on the Receivable Schedule to and from the bank statements, confirming the total amount paid to Orecchio. (Tr. 220, 1441-42; Div. Ex. 67.)

McNeeley went on vacation beginning May 20, 2005, for two weeks. (Tr. 159.) On June 7, 2005, McNeeley initiated a series of e-mails with Stevens in which she attempted to solidify her understanding of the Transfers. (Tr. 243-54; Resp. Ex. 129.) McNeeley sought to understand the reason behind a significant increase in AA Capital's Fees/Accounts Payable account in 2004 and clarify that the tax accruals included in this account noted as "John's tax payment" were for the corporation and not for personal tax liabilities of the shareholders. (Tr. 244-45; Resp. Ex. 129.) Contrary to McNeeley's assumption that the payments were for corporate taxes, Stevens replied that the tax accruals were, in fact, related to Orecchio and that "John was dinged by the IRS and incurred multiple fees and tax payments."[16] (Tr. 246; Resp. Ex. 129.) Stevens said that most of the amounts were not correct, but could not be settled with the IRS until the audit and tax work were completed.[17] (Id.)

Also on June 7, after the e-mail exchange with Stevens, McNeeley documented her understanding of the Transfers in a note on the front of a workpaper supporting the work performed on the Receivable Schedule:

> Note: Per the last page of N2, the Equity fund made approx. 1,921,304 of tax payments for John Orrechio [sic] during 2004. [T]he Equity fund has set up a receivable from AA Capital Partners for reimbursement of this amt. E&Y verified that AA Cptl Ptrns has a reciprocal payable balance to Equity. E&Y also

[16] In August 2004, Orecchio e-mailed Stevens regarding tax liabilities he owed to the IRS. (Div. Ex. 54.) Orecchio requested that Stevens prepare reimbursements for two checks he paid to the IRS in amounts of approximately $25,000 and $165,000. (Id.) Orecchio provided Stevens with copies of the two checks made payable to the U.S. Treasury. (Id.) Orecchio also provided Stevens with IRS correspondence supporting the $25,000 assessment, representing penalties and interest for unreported taxable interest income from an AA Capital fund in 2002. (Id.) He represented to Stevens that the $165,000 payment represented estimated tax payments for 2003. (Id.)

In September 2004, Orecchio requested Stevens wire to him $579,000, representing an amount paid personally by Orecchio as a result of negotiations with the IRS over his 2003 personal tax liability. (Div. Ex. 55.) Orecchio indicated he would provide Stevens with a copy of the check and IRS letter supporting the payment. (Id.)

In November 2004, Orecchio asked Stevens to reimburse him for a $550,000 tax payment purportedly made to the IRS, using personal funds he withdrew from his IRA; he represented that he would provide Stevens with a copy of the check and transmittal letter to the IRS. (Div. Ex. 56.)

[17] Stevens did not testify and advised that if called as a witness, she would invoke her Fifth Amendment privilege. (Stip. 35.)

> noted that AA Cptl has an offsetting receivable balance from John Orrechio [sic]. Appears proper.

(Tr. 253, 497-98; Div. Ex. 67.) In discussing the Receivable Schedule, McNeeley asked Stevens to provide "any and all documentation that she had regarding the tax advances." (Tr. 221-22.) McNeeley could not recall receiving specific documentation in response to her request, but noted that in addition to the Receivable Schedule, the audit team had other documentation supporting the Transfers, including the general ledger, the management representation letters, and the Partnership Agreement. (Tr. 222-25.) The general ledger showed the detail of the individual purported tax payments, the dollar amounts, and dates paid. (Tr. 225.) McNeeley acknowledged that the Receivable Schedule provides details of account balances and transactions that are recorded in the general ledger; both documents were prepared by Stevens. (Tr. 254-56.)

The management representation letters, signed by Stevens and Orecchio, represented to E&Y that the accounting records were complete and accurately reflected all of the company's transactions.[18] (Tr. 225, 264-65; Resp. Ex. 15.) The management representation letter for the Equity Fund included a representation that all related-party transactions were properly recorded or disclosed in the financial statements, but did not reference explicitly the Transfers to Orecchio. (Tr. 271, 1321-22; Resp. Ex. 15.)

McNeeley reviewed the Partnership Agreement at the beginning of the audit to gain an understanding of the important provisions; she did not recall whether she reviewed the Partnership Agreement specifically in connection with her analysis of the Transfers. (Tr. 257.) The Partnership Agreement, as McNeeley understood it, permitted tax distributions and tax advances. (Tr. 420.) Tax distributions to partners were permitted to pay an actual tax liability; tax advances were permitted to pay estimated tax payments. (Tr. 421.) Tax advances required the partner to repay any advance made in excess of the actual liability. (Id.) Based on Stevens' representations, McNeeley believed that Orecchio's tax liability, purportedly the result of an erroneous tax assessment, fell into the tax advance category, as provided for in the Partnership Agreement. (Tr. 421-23.)

McNeeley did not inquire about Orecchio's actual tax liability, and could not recall if she inquired during the audit if he could repay the Transfers. (Tr. 319-21.) McNeeley did not recall contacting the E&Y tax team to discuss Orecchio's "tax loan" or the type of tax liability that persons with an interest in the Funds might incur. (Tr. 273.) She noted that the tax team would not have had the information necessary to evaluate Orecchio's personal tax position.[19] (Id.)

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[18] Each AA Capital related fund had its own management representation letter. (Tr. 1322-23.) These letters included representations by Orecchio and Stevens that they had no plans that might materially alter the carrying value or classification of its assets and that they had complied with all aspects of contractual agreements, including the Partnership Agreement. (Tr. 1320-21; Resp. Ex. 15.)

[19] Haas testified that a million dollar tax liability would not be unusual, particularly in light of the fact that the IRS' tax treatment of the merger of several funds into the Equity Fund might have created unexpected and potentially significant tax liabilities. (Tr. 1670-71, 1675-76.) Haas had often seen multi-million dollar mistakes assessed against individuals for any number of reasons,

There was no separate loan agreement. (Tr. 58, 319-20.) McNeeley was comforted by the fact that Oliver knew about the Transfers. (Tr. 368-69, 417.) McNeeley spoke with Stevens, but did not recall any member of the audit team ever speaking with Orecchio or Oliver about the Transfers. (Tr. 225-26.) McNeeley did not receive any documentation, including fake or forged documentation, relating to the existence of the tax liability. (Tr. 275-77.)

Oprins reviewed the note written by McNeeley on June 7, 2005, summarizing her understanding of the Transfers. (Tr. 492-93, 497-98.) He did not consider the Transfers a "red flag" because he was aware, from previous discussions with Wall, of the tax issues being faced by Wall, Orecchio, and Oliver. (Tr. 499.) Oprins could not recall the specific audit steps taken with respect to the Transfers, including at what point during the audit he reviewed the Partnership Agreement.[20] (Tr. 503-04, 586.) Oprins' only time on site during the 2004 Audit was for opening and closing meetings with the client. (Tr. 506.) Oprins considered the Transfers to be a material related-party transaction. (Tr. 510.)

6. Subsequent Review Testing

As part of the audit procedures for 2004, the audit team performed subsequent review testing, which is a substantive audit procedure designed to gather evidence about the reasonableness of account balances as of December 31, 2004, by reviewing transactions occurring after that date. (Tr. 929.) The workpapers indicated that disbursements during the period January 1, 2005, through March 31, 2005, were reviewed for significant unusual items. (Tr. 931-32; Div. Ex. 60 at 27-28.) McNeeley performed the review, noting "no unusual items," and no additional documentation was included in 2004 audit workpapers. (Div. Ex. 60 at 27; Tr. 931-33.)

However, AA Capital's 2005 accounts receivable schedule revealed several significant additional advances to Orecchio, including multiple disbursements on the same day. (Tr. 932-33; Div. Ex. 92.) During January and February 2005, AA Capital made nine disbursements to Orecchio totaling $482,000, described as "J.O. taxes," "JO Tax Distrib," or "JO Tax Dist."[21] (Div. Ex. 92 at EYZ000798.) This meant that prior to E&Y's issuance of the 2004 Audit reports, McNeeley knew or should have known that the $1.92 million in Transfers had increased to over $2.4 million. (Div. Ex. 98 at 42.)

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including improper employer identification numbers, simple number transpositions, and other clerical errors. (Tr. 1677.) In his experience, there was nothing unusual about the fact that Orecchio made purported estimated tax payments on dates other than the usual quarterly dates beginning April 15, or the fact that the quarterly payments were in different amounts. (Tr. 1680-81.)

[20] The Division's expert determined that Oprins was not aware of any audit procedures performed in regard to the Transfers, other than representations from Stevens. (Div. Ex. 98 at 30.)

[21] On February 22, 2005, a single disbursement was made to Orecchio in the amount of $266,000. On the same date, a second disbursement was made to him in the amount of $14,000. (Div. Exs. 92 at EYZ000798, 98 at 42.)

7. Financial Statement Disclosure of the Transfers

McNeeley understood that the Transfers were related-party transactions and quantitatively material, subject to the guidance in FAS 57 and AU § 334.[22] (Tr. 278.) The Transfers were reflected in both the $2.534 million "Fee and accounts payable" line and the $2.251 million "Accounts receivable from affiliates" line on AA Capital's 2004 Statement of Financial Condition. (Tr. 280-81, 287-89; Div. Ex. 29 at 2.) AA Capital's financial statement included a related-party Note that described approximately $264,000 in reimbursable expenses included in the "Accounts receivable from affiliates" line. (Tr. 289-91; Div. Ex. 29 at 8.) There was no mention of the Transfers specifically to Orecchio in the AA Capital financial statement. (Tr. 291; Div. Ex. 29 at 8.) The Equity Fund showed the $1.92 million as "Accounts receivable from AA Capital Partners, Inc." (Tr. 307-08.) There was no disclosure in the "Notes to Financial Statements" regarding the fact that money from the Equity Fund ultimately went to Orecchio for a "tax loan" or "tax distribution." (Tr. 315; Div. Ex. 31 at 7-14.)

In order to review the financial statement disclosures, McNeeley prepared and Oprins reviewed, the GAAP Disclosure Checklist. (Tr. 322-23, 512; Div. Ex. 30.) Oprins opined that there is a range of financial statement disclosures that may be compliant with GAAP, and, while the disclosure of the Transfers was not at the "high end," it met minimum standards. (Tr. 590.) The level of disclosure was determined by the client; the audit team's obligation was to ensure that the client's disclosure complied with GAAP. (Tr. 630.)

Oprins believed that AA Capital's financial statement was not being distributed to anyone other than Orecchio and Oliver, the sole shareholders.[23] (Tr. 591.) With respect to the Equity Fund, Oprins understood the financial statement would be provided to investors. (Tr. 592.) Oprins agreed that the application of GAAS does not change depending on who the users of the financial statements are, nor do GAAP disclosure requirements change based on whether the financial statements are tax-based or presented in conformity with GAAP. (Tr. 633-34.)

The issue regarding the Transfers was not brought specifically to the attention of Kavanaugh, nor was it included in the Summary Review Memorandum (SRM), as would have been Kavanaugh's preference.[24] (Tr. 737-38; Div. Ex. 58.) Kavanaugh noted that the financial statements for AA Capital and the Equity Fund did not specifically identify the Transfers to Orecchio, though such disclosure was not absolutely required. (Tr. 745.) However, Kavanaugh testified that had such disclosure been made, it may have prompted questions from him concerning the nature of the Transfers and their permissibility under the Partnership Agreement. (Tr. 745-46.)

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[22] FAS 57 and AU § 334 are discussed <u>infra</u>.

[23] Oprins' belief was bolstered by the fact that the AA Capital's financial statements were prepared on a tax basis, which limits their usefulness to outside parties. (Tr. 591-92.)

[24] The SRM is a document completed by the audit team near the end of the audit that summarizes key accounting and auditing matters that arose during the audit and the core team's ultimate conclusions regarding the audit and the opinion(s) to be issued. (Tr. 732-33.)

C. AA Capital's Fraudulent Activity Is Discovered

E&Y was engaged to audit AA Capital and its related Funds, including the Equity Fund, for the year ended December 31, 2005. (Tr. 442-43; Div. Ex. 43.) Jennifer Aquino (Aquino) replaced McNeeley as the audit manager because McNeeley was on maternity leave. (Tr. 443-44, 524.) The majority of the 2005 audit team remained the same as in 2004, including Oprins as engagement partner, and Palko and Apau as audit seniors. (Tr. 443, 524-25.) Audit planning for the 2005 audits occurred in May 2006.[25] (Div. Ex. 43; Resp. Ex. 87.)

Aquino asked Stevens for documentation supporting the Transfers, but never received anything. (Tr. 642.) She stated that, other than inquiry of Stevens and sending an e-mail to Orecchio, there were no other audit procedures to perform on the Transfers "because [the audit team] didn't have anything to audit." (Tr. 644.) Aquino testified that the audit team's approach with respect to the Transfers was influenced by the fact that the 2004 "tax receivable" still existed on the books in 2005, even though it should have been repaid within one year, and had increased substantially since the 2004 Audit. (Tr. 691-92.) By the end of December 2005, the Transfers had grown to $5.7 million. (Tr. 525.)

The audit team held several internal discussions regarding the status of the Transfers. (Tr. 643.) At one meeting, the audit team determined that it would not proceed with the 2005 audit until Orecchio paid back the "tax loan" and they received sufficient documentation to audit the Transfer balance. (Tr. 662-63.) On June 30, 2006, Oprins informed Stevens and Orecchio that E&Y would not release their 2005 audit opinions until the Transfers were paid back. (Tr. 528-29; Div. Ex. 37.) The audit team also raised a "going concern" regarding AA Capital's ability to fund its own operations. (Tr. 670; Div. Ex. 34.) The 2005 audit reports were never issued because the audit team was unable to resolve these open items. (Tr. 527, 676-77; Div. Ex. 41.)

In August 2006, the SEC conducted a "for cause"[26] on-site examination of AA Capital to investigate the possibility that AA Capital was using a solicitation firm to unlawfully obtain clients in a kickback scheme.[27] (Tr. 49.) The examination staff (Staff) included Andrew Schuster (Schuster), Branch Chief in the Division of Investment Management, and two securities compliance examiners. (Tr. 47, 50.) Schuster testified in this proceeding regarding the 2006 examination. (Tr. 46.)

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[25] Aquino signed off on the 2005 ICFC and ASM on May 3, 2006, and May 10, 2006, respectively. (Tr. 445-47, 455-56; Resp. Ex. 87; Div. Ex. 43.)

[26] More often, the SEC's examination staff conducts "routine" examinations of registered investment advisers, such as AA Capital, to evaluate a firm's compliance with federal securities laws. (Tr. 48.)

[27] The SEC received a tip from the U.S. Department of Labor regarding possible impropriety. (Tr. 70.)

During the examination, the Staff spoke with Stevens, Orecchio, Oliver, Matt Friezl, and Jennifer Pedico.[28] (Tr. 50.) The Staff raised a concern over AA Capital's failure to maintain current financial statements and the fact that AA Capital's 2005 financial statements were still in draft form in August 2006.[29] (Tr. 51-53.) The Staff was informed by Stevens that the 2005 audited financial statements would be completed after Orecchio paid back a personal loan. (Tr. 54.) Stevens, appearing nervous, also informed the Staff that Orecchio had borrowed approximately $5 million from the Equity Fund in order to satisfy a tax liability arising from his ownership in AA Capital and the Funds. (Tr. 57-58.) In response to questions from the Staff, Stevens replied that she was not aware of any note or other documentation for the loan, disclosures to clients about the loan, or interest charged on the loan. (Tr. 58.) Stevens indicated that she maintained a file of IRS documents on the loan. (Tr. 59.) After discussions with Stevens, Oliver, and Orecchio, the Staff developed concerns regarding possible misappropriation of assets. (Tr. 60-61.) Orecchio indicated that, on the advice of counsel, he would not answer questions regarding the tax loan. (Tr. 62.)

On September 12, 2006, Oprins learned from Stevens that W. Scott Porterfield (Porterfield) was appointed the receiver over AA Capital. (Tr. 98-99, 534-35; Div. Ex. 39.) On September 14, 2006, the audit team held a conference call at which they discussed the fact that AA Capital had been placed into receivership and reminded everyone to preserve the audit workpapers and related documentation. (Tr. 536-37; Div. Ex. 46.) On October 11, 2006, Oprins informed Porterfield that E&Y was pulling back its 2004 audited financial statements for AA Capital and related entities due to the subsequent discovery of facts existing at the date of the audit reports.[30] (Tr. 537-38; Div. Ex. 40.)

D. Expert Testimony

The Division called one expert witness, John Barron (Barron), and Respondents called two experts, John Ellingsen (Ellingsen) and Alan Funk (Funk).

1. John Barron

The Division retained John Barron to opine on whether the financial statements of AA Capital and the Equity Fund, for the year ended December 31, 2004, were fairly presented in accordance with GAAP, and whether the audits of these entities were performed in accordance with GAAS.[31] (Tr. 788; Div. Ex. 98 at 1.) Specifically, Barron evaluated the conduct of Oprins

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[28] Matt Friezl was an analyst at AA Capital and Jennifer Pedico was in the marketing department. (Tr. 50-51.)

[29] Most registered investment advisers comply with the Custody Rule by distributing audited financial statements to clients within 120 days of the end of its fiscal year (180 days for a fund of funds). (Tr. 53.)

[30] AU § 561 provides guidance to auditors in the situation where the auditor discovers facts after the date of the audit report that put into question the reliability of the financial statements. (Tr. 539.)

[31] Barron, a CPA, is an honors graduate of the University of Florida, with a bachelor's degree in business administration and major in accounting. (Div. Ex. 98 at 1.) Barron is currently a

and McNeeley with respect to these audits and concluded that their performance on the 2004 Audit was an extreme departure from auditing standards. (Div. Ex. 98 at 1, 8; Tr. 1074.) Barron's review focused primarily on audit workpapers relating to the $1.9 million in Transfers, audit planning, risk assessment, internal controls, the SRM, and summary of adjustments passed; he did not review other significant areas of the audit not at issue in this proceeding, including investments and valuation. (Tr. 1104.) Barron opined that because of the violations of GAAS and GAAP with respect to the Transfers, the 2004 financial statements for AA Capital and the Equity Fund taken as a whole, were materially misstated. (Tr. 1106; Div. Ex. 98 at 14.)

a. Inadequacy of Disclosures in Conformity with GAAP

Barron opined that the Transfers were material related-party transactions, as defined by GAAP.[32] (Tr. 810; Div. Ex. 98 at 5, 11-12.) As such, Statement of Financial Accounting Standards No. 57 (FAS 57), Related Party Disclosures, required specific disclosures in the 2004 financial statements. (Tr. 810.) FAS 57 requires that financial statements disclose: (i) the nature of the relationships involved; (ii) a description of the transactions and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements; (iii) the total dollar amount of the transactions; and (iv) the amounts due from or to any related parties and, if not otherwise apparent, the terms and manner of settlement.[33] (Div. Exs. 98 at 10-11, 99-A.) Barron testified that with respect to related-party disclosure, the question is not whether what was presented was fair or accurate, but whether something was omitted that would be necessary to allow a user to fully understand the implications of the transaction. (Tr. 819-20.) He acknowledged that auditor judgment plays a role in assessing what is required to be disclosed in the financial statements. (Tr. 1056.) According to Barron, as required under FAS 57, "understanding the effects of the transactions on the financial statements" should be construed broadly to include the importance of the disclosure to the users.[34] (Tr. 1063-67; Div. Ex. 99-A.)

AA Capital's financial statements were prepared on a tax basis. (Tr. 803.) Barron noted that with respect to related-party transactions, the disclosure obligations under GAAP also

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Director in the Litigation and Corporate Advisory Services Group of Marks Paneth & Shron (MPS). (Id.) MPS is a regional public accounting firm that provides accounting, auditing, tax, and consulting services. (Id.) Barron is also an adjunct professor of accounting and auditing at Zicklin School of Business at Baruch College, City University of New York, and a member of the Auditing Standards Committee of the New York State Society of CPAs. (Id.) Barron previously held positions of senior audit manager and partner in the firm of Haskins & Sells, which later became Deloitte & Touche (Deloitte), spending a total of 22 years with the firm. (Div. Ex. 98 at 1; Tr. 794.)

[32] Barron opined that the Transfers were "material" because, given the amount and nature of the Transfers, the judgment of a reasonable person relying on such information would have been changed or influenced by the inclusion of this information. (Div. Ex. 98 at 12.)

[33] Respondents' expert, Ellingsen, agreed that FAS 57 applied to the Transfers. (Resp. Ex. 431A at 58-59; Tr. 1345.)

[34] Barron's opinion is based on items 12-18 of Appendix A to FAS 57, which provides background information. (Tr. 1065-67; Div. Ex. 99-A at FAS57-3.)

applied to financial statements prepared on a tax basis. (Tr. 804.) Barron opined that by not providing additional disclosure regarding the $1.92 million receivable from Orecchio in "Accounts receivable from affiliates," users of AA Capital's financial statements would be misled into believing that the total amounts due from affiliates arose in the ordinary course of business, which in Barron's opinion, was not the case. (Tr. 824-25; Div. Ex. 98 at 14.) Barron noted that there was no disclosure with respect to the loan to Orecchio or its purpose, the nature of the relationship associated with the transaction, the terms and manner of settlement of the receivable, or the identity of Orecchio, an officer, as the recipient of a loan. (Tr. 825-26; Div. Ex. 98 at 14.)

Barron similarly opined that by including the $1.92 million borrowing from the Equity Fund within the $2.5 million "Fee and accounts payable" caption, users of AA Capital's financial statements would be misled into believing the loan transaction arose in the ordinary course of business, and have no way of knowing that the funds were obtained from the Equity Fund for the purpose of paying Orecchio's personal tax liability. (Tr. 825; Div. Ex. 98 at 14.) Barron opined that the disclosure of "reimbursable expenses" in Note 6, including the names of the parties involved, was an example of "excellent disclosure." (Tr. 822-23.) He contrasted this with the lack of disclosure regarding the Transfers—failing to disclose the substantive purpose of the Transfers, or the name/nature of the party involved. (Tr. 823-24, 1070.)

With regard to the Equity Fund, Barron opined that the use of the term "accounts receivable" to describe the Transfers failed to convey the unusual nature of the transaction, as well as the purpose of the "loan" to AA Capital and the ultimate use of funds by Orecchio. (Tr. 828-30; Div. Ex. 98 at 14.)

b. Failure to Comply with GAAS

Barron opined that Respondents failed to comply with GAAS during the 2004 Audit when they caused E&Y to issue unqualified audit opinions despite inadequate financial statement disclosures, and failed to: (i) properly plan the audit and adequately assess the risks of material misstatement; (ii) obtain sufficient competent evidential matter with respect to the Transfers; and (iii) exercise due professional care. (Div. Ex. 98 at 6-8, 18.) Barron further opined that Oprins, as the engagement partner, failed to adequately supervise the audit. (Div. Ex. 98 at 8, 24-25.) He testified that the audit standards required under GAAS and applied to general purpose financial statements would apply equally, regardless of the number of potential users.[35] (Tr. 840.) He also stated that while an auditor is not expected to document every conversation held in connection with testing a balance or transaction, the auditor should document in the workpapers the evidence examined and the basis for the conclusion reached. (Tr. 1155.)

i. Audit Planning and Risk Assessment

Auditors are required to plan their audits and identify risks of material misstatement. (Div. Ex. 98 at 19; AU §§ 312, 316.) Auditors should modify their procedures to address the

[35] Restricted-use financial statements would be identified as such in the engagement letter and auditor's report. The 2004 Audit reports were not restricted. (Tr. 839-40.)

identified risks, including the risk of fraud. (Id.) Barron opined that Respondents failed to adequately assess the risk posed by the Transfers. (Div. Ex. 98 at 23-24.) Specifically, he opined that the amount and purported purpose of the Transfers did not represent a transaction commonly occurring in the normal course of AA Capital's business. (Div. Ex. 98 at 19-20, 25.) Instead, the Transfers were funded from the Investor Trust Accounts, which were designated to make investments and pay reimbursable expenses and management fees. (Div. Ex. 98 at 19-20.) An audit checklist item required the audit team to "gain an understanding of the business rationale for [significant transactions outside the normal course of business] and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to . . . conceal misappropriation of assets."[36] (Div. Ex. 98 at 21-22.) McNeeley checked "none noted." (Div. Ex. 98 at 21.) Barron opined that McNeeley was incorrect to indicate "none noted," implying that the Transfers were not outside the normal course of business. (Tr. 863-64.)

Barron also opined that Respondents failed to consider certain fraud risks identified in the ICFC, including large amounts of cash on hand and inadequate segregation of duties. (Div. Ex. 98 at 21; Tr. 882-84.) According to Barron, Respondents failed to assess the risks associated with the fact that there were no effective procedures in place to monitor the actions of Orecchio, or otherwise prohibit management from exercising significant influence over transactions in which that person was a party. (Div. Ex. 98 at 23.) Barron noted that even though he believes the audit team properly decided not to rely on internal controls, they failed to identify Orecchio's ability to direct transactions to himself as a control risk and risk of fraud. (Tr. 889-90.)

ii. Sufficient Audit Evidence

AU § 150.02 requires auditors to obtain sufficient competent evidential matter, through inspection, observation, inquiries, and confirmations, to afford a reasonable basis for an opinion regarding the financial statements under audit. (Div. Ex. 98 at 26.) AU § 334.09 provides guidance to auditors examining identified related-party transactions: "[T]he auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management." (Div. Exs. 98 at 27, 99-L at 409; Tr. 892-93.)

Barron's review of the workpapers indicated that with respect to the Transfers, the audit team obtained the Receivable Schedule, traced certain amounts to bank statements, and documented Stevens' explanation for the Transfers. (Tr. 897.) Barron noted that the work performed on the Receivable Schedule included inquiring of management; agreeing certain disbursements to bank statements; examining supporting invoices (but not with respect to any of the "tax loans" to Orecchio); testing the mathematical accuracy of the schedule; and summarizing certain categories of expenses. (Tr. 896-98.) Barron opined that the evidence obtained with respect to the Transfers, and the fact that McNeeley received nothing in response to her request from Stevens for "anything and everything she could provide" supporting the Transfers, was not sufficient evidence. (Div. Ex. 98 at 29.) He testified that other than

[36] The audit checklist item was part of E&Y's Program for General Audit Procedures (PGAP). (Div. Ex. 60.)

management inquiry, the only procedure the audit team performed was its work on the Receivable Schedule—a schedule prepared by a client with poor internal controls, which meant that such evidence did not offer any real audit assurance.[37] (Tr. 898.)

Barron believed that given the nature of the evidence the audit team had, under AU § 334.09, the audit team should have reviewed the provisions of the Partnership Agreement to determine if the Transfers were made in accordance with that agreement. (Tr. 898-99.) Barron understood that McNeeley had, at one point, reviewed the Partnership Agreement, but she did not specifically compare its terms with Stevens' representation of the nature of the Transfers. (Tr. 900.) He stated that it would be reasonable not to review the Partnership Agreement specifically in connection with the Transfers, if McNeeley, based on her prior understanding, was able to recall the precise provisions and how they worked. (Tr. 1013-14.) Barron did not know whether McNeeley had this level of understanding. (Id.)

Barron opined that the first thing he would have done in auditing this type of transaction would have been to review the Partnership Agreement, which might have yielded sufficient audit evidence by itself. (Tr. 913.) He testified that a "sufficient understanding" that the Partnership Agreement allowed for tax advances of this kind and that the amount of the advance was reasonable (based on a review of the earnings of the Equity Fund) would have been sufficient audit evidence. (Tr. 1019.) If the auditors failed to satisfy themselves after reviewing the Partnership Agreement, Barron believed other logical evidence that should have existed and been obtained might include a copy of a cancelled check and/or evidence of the tax assessments.[38] (Tr. 914-15.) Barron also found it unusual that the audit team examined supporting invoices with respect to a number of other payments to Orecchio shown in the Receivable Schedule, but the only procedures performed with respect to the $1.92 million in Transfers was the discussion with Stevens and vouching the payments to bank statements. (Div. Ex. 98 at 29-30.)

Barron opined that, based upon Stevens' representations regarding the Transfers, the audit team should have requested and reviewed other audit evidence, including (i) third party documentation of Orecchio's payment of the $1.92 million to the IRS; (ii) IRS correspondence related to such payments; and (iii) evidence of Orecchio's financial ability to repay the loans. (Div. Ex. 98 at 32.) In addition, Barron stated that the audit team should have performed additional analysis of the Transfers and inquired further into Orecchio's (i) possible tax liabilities arising from his interests in the AA Capital-related entities; (ii) partnership capital balance in the Equity Fund, in relation to the Transfers; and (iii) personal tax situation, including discussions with Orecchio, personally. (Div. Ex. 98 at 32.) Barron noted that Aquino testified that she would have likely performed several of these procedures with respect to the Transfers had the 2005 audit gone forward. (Div. Ex. 98 at 32.)

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[37] Barron acknowledged that receipt of the management representation letter, while it did not contain any specific representations regarding the "tax loan" to Orecchio, was additional audit evidence, but that the management representation letter was yet another form of management inquiry. (Tr. 910.)

[38] Barron noted another possible audit procedure would have been to contact Orecchio's personal tax preparer. (Tr. 916; Div. Ex. 98 at 32.)

GAAS provides that the existence of collusion among members of management, employees or third parties may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. (Div. Exs. 98 at 33, 99-F at 45, AU § 230.12.) Barron opined that the evidence obtained, including the Receivable Schedule, vouching to bank statements, and the representations of Stevens, was not part of a sophisticated scheme designed to conceal fraud, such as those involving forgery or a deliberate failure to record transactions. (Div. Ex. 98 at 33.) Barron testified that, with respect to the Transfers, the audit team did not receive or rely upon evidence that appeared persuasive, but was not, due to fraud. (Tr. 937-39.)

Barron opined that because the Transfers were related-party transactions, the audit team was required to perform audit procedures beyond inquiry of management and obtain persuasive audit evidence, which it failed to do. (Div. Ex. 98 at 33-34.) In Barron's opinion, Stevens' failure to provide any supporting documentation other than the Receivable Schedule should have alerted the audit team to seek corroborative evidence. (Div. Ex. 98 at 34.) Barron also noted that several key questions were raised about the Transfers during the 2005 audit that, in his opinion, should have been raised in 2004, such as whether the loans to Orecchio were authorized under the relevant corporate documents, and whether the Transfers were a breach of fiduciary duty. (Div. Ex. 98 at 35.)

iii. Due Professional Care

AU § 230.01 requires that auditors exercise due professional care in planning and performing their audits and preparing audit reports. (Div. Ex. 99-F at 43.) Due professional care requires the auditor to exercise professional skepticism, which includes a questioning mind and critical assessment of audit evidence. (Div. Ex. 99-F at 44, AU § 230.07.) The auditor neither assumes that management is dishonest, or assumes unquestioned honesty; the auditor should not be satisfied with less than persuasive audit evidence because of a belief that management is honest. (Div. Ex. 99-F at 44, AU § 230.08-.09.) Examples of the application of professional skepticism in response to the risks of material misstatement due to fraud include obtaining additional corroboration of management's representations and designing additional audit procedures to obtain more reliable audit evidence. (Div. Ex. 99-I at 140, AU § 316.46.)

Based on McNeeley's testimony that she did not read the Partnership Agreement specifically with respect to evaluating the Transfers, Barron found that McNeeley failed to recognize that the Transfers were not permitted under the Partnership Agreement. (Div. Ex. 98 at 31-32.) Section 7.3.1 of the Partnership Agreement provides for "tax distributions" to partners "equal to the aggregate federal, state and local income tax liability such Partner would have actually incurred as a result of such Partner's ownership interest in the Partnership . . . ." (Div. Ex. 98 at 31; Resp. Ex. 216 at 19.) Section 7.3.3 provides that the partnership may make "Tax Distributions" to partners to enable them to satisfy their liability to make estimated tax payments with respect to each fiscal year based on calculations of the partner's estimated tax liability pursuant to 7.3.1. (Div. Ex. 98 at 31; Resp. Ex. 216 at 20.) Barron opined that a "distribution," a term referring to payments made from a partner's capital balance, is different than a "loan," which is ultimately how AA Capital characterized the Transfers on its 2004 financial statements.

(Div. Ex. 98 at 31.) As a result, Barron opined that McNeeley should have realized that the Transfers were not permitted under the Partnership Agreement. (Div. Ex. 98 at 31-32.)

Barron's review of the 2004 workpapers did not reveal any attempt by Respondents to question the reasonableness of the Transfers, beyond McNeeley's documentation of Stevens' representation, noting "appears proper." (Tr. 917-18; Div. Ex. 67 at EY04000544.) According to Barron, McNeeley should have asked follow up questions when she learned of certain discrepancies, including that the Transfers were characterized as both "tax loans" and "tax distributions," and that the purpose of the Transfers was described as both the payment of estimated taxes and an *erroneous* tax assessment. (Tr. 919-21.) The distinctions in both cases were important. (Tr. 921-22.) Barron also opined that Respondents failed to raise questions about anomalies in the structuring and payment of the Transfers. (Tr. 923-24.) For example, the audit team should have raised questions as to why all of the Transfers were paid from the Equity Fund,[39] and why the Transfers were not first distributed to the general partner, rather than to Orecchio, as required under the Partnership Agreement. (Id.)

Barron opined that the audit team failed to assess the reasonableness of the purported "tax loans" or prepare a basic calculation estimating the amount of taxable income that would reasonably be expected to flow to Orecchio as a result of his ownership interests in the AA Capital-related entities for 2003 and 2004.[40] (Tr. 925-26; Div. Ex. 98 at 38-39.) Barron opined that the income taxes attributable to Orecchio for 2003 and 2004 should not have exceeded $45,000, and that such a discrepancy should have been identified and investigated. (Div. Ex. 98 at 39.) Barron further opined that the audit team failed to evaluate the reasonableness of the Transfers in light of the large discrepancy in the tax loans taken by Orecchio ($1.92 million) and Oliver (approximately $18,000), both fifty percent owners in AA Capital, and the fact that the Transfers, classified as "distributions" in the Partnership Agreement, were more than seven times Orecchio's ultimate share of capital in the Equity Fund. (Div. Ex. 98 at 40-41; Tr. 927.)

iv. Oprins' Failure to Supervise

Barron opined that Oprins failed to cause additional audit procedures to be performed with respect to the Transfers, despite his awareness and understanding of the Transfers.[41] (Div. Ex. 98 at 24.) He also opined that Oprins was not aware of any other audit procedures performed on the Transfers beyond the conversations held between McNeeley and Stevens. (Id.) Barron further stated that in his experience, the time required by a partner to properly plan and supervise an audit averages ten percent of the total engagement hours. (Div. Ex. 98 at 25.) Therefore, Barron determined that Oprins' thirty hours of time spent on the 2003 and 2004 audits fell well

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[39] Rojas' description of the Transfers noted that "all of the Funds held under AA Capital had not finalized their audits . . . ." (Tr. 923; Div. Ex. 67 at EY04000555.)

[40] The 2003 and 2004 tax returns had not been prepared at the time E&Y issued its audit reports. (Div. Ex. 98 at 38.)

[41] After McNeeley documented Stevens' explanation for the Transfers in the audit workpapers, she concluded "appears proper," to which Oprins documented his review and approval. (Tr. 941.)

below his expectation that Oprins should spend approximately eighty hours on the engagement.[42] (Id.) According to Barron, it was also unusual for the entire engagement team to spend more time on the audits than expected, without a proportional increase in time spent by the engagement partner.[43] (Tr. 943-44.)

2. John Ellingsen

John Ellingsen was retained by Respondents to opine on their conduct in connection with the audits of the 2003 and 2004 financial statements of AA Capital and the Equity Fund.[44] (Tr. 1225-26; Resp. Ex. 431A.) Ellingsen opined that the audit work of Respondents, including with respect to the Transfers, was performed in accordance with both GAAS and GAAP and consistent with the reasonable exercise of professional judgment. (Resp. Ex. 431A at 4; Tr. 1248-49.) He based his opinion, in part, on the fact that numerous other AA Capital-related audits conducted simultaneously, which included hundreds of audit procedures in many areas other than the purported "tax advances," remain unchallenged by the SEC. (Resp. Ex. 431A at 29.) He found that the audit procedures performed in certain key audit areas, including investments, intercompany accounts receivable/payable, and partners'/members' capital, were performed in accordance with GAAS.[45] (Resp. Ex. 431A at 30.) The audit team also examined management and consulting fees, and other expenses. (Tr. 1286-88; Resp. Ex. 431A at 52-54.) Ellingsen found the audit procedures in the area of expenses, which consisted of recalculations, confirming with applicable agreements, and analytical procedures, complied with GAAS. (Tr. 1288; Resp. Ex. 431A at 52.) According to Ellingsen, the judgments made regarding the Transfers must not be viewed in isolation, but rather in light of all of the work performed on the 2003 and 2004 audits. (Resp. Ex. 431A at 30.)

Ellingsen also opined that documents in AA Capital's files demonstrated an intent to interfere with and/or hide information from the audit team. (Resp. Ex. 431A at 101.) He cited a March 30, 2005, Orecchio e-mail to Stevens asking her to "wire $180,000 to roxy tomorrow? Add it to my receivable for the new entity." (Resp. Ex. 431A at 100.) Stevens replied:

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[42] Barron estimated eighty hours as ten percent of the audit team's 789 hours of actual time spent. (Div. Ex. 98 at 25.)

[43] Barron noted that, for example, the audit team spent approximately 200 more hours on the audits than expected; McNeeley's actual time spent went up significantly, but Oprins' time spent increased by only a few hours. (Tr. 943.)

[44] Ellingsen, a CPA, holds a B.S. in accounting and an MBA from the University of California, Berkeley. (Tr. 1227, 1238; Resp. Ex. 431A at Ex. A.) He was an auditor with Deloitte for 36 years, including 25 years as a partner. (Resp. Ex. 431A; Tr. 1236.) While at Deloitte, Ellingsen spent approximately six years as the National Partner in Charge of Deloitte's Auditing Policies and Procedures. (Resp. Ex. 431A at 2.) He was a member of the AICPA's Auditing Standards Board from 1983 to 1987, during which time he participated in the drafting of several Statements on Auditing Standards. (Id.)

[45] Other than with respect to the Transfers, the OIP does not allege any deficiencies in the audit team's work.

> John, I am just not comfortable in doing this transaction in light of the auditors coming in the next few weeks. I think we should push it off until we can get the new companies up, running, and funded. I have a feeling that we will be getting an earful from E&Y on the co-mingling of funds and the level and type of expenses we have incurred to date. I think we should hold off and find the appropriate strategy going forward.

(Resp. Ex. 431A at 101.)

a. Audit Planning and Supervision Complied with GAAS

Ellingsen opined that Respondents' audit planning and supervision complied with GAAS. (Resp. Ex. 431A at 30.) He found that the audit team obtained and documented its understanding of AA Capital's business through previous experience with AA Capital, management inquiry, review of governing agreements, and preparation of various planning workpapers. (Resp. Ex. 431A at 32.)

Ellingsen opined that Respondents adequately assessed audit risks, including the risk of material misstatement due to fraud. (Resp. Ex. 431A at 33-34.) He noted that several risks were identified in the ICFC, including the ability to attract future investors based on profitability and historical performance and the marketability of its investments. (Resp. Ex. 431A at 34.) Ellingsen disagreed with Barron's judgment that they failed to assess certain risk factors described in AU § 316.85, including inadequate segregation of duties or independent checks. (Resp. Ex. 431A at 34-35.) He noted that the audit team concluded, in its judgment, not to rely on AA Capital's controls, and that its policies and procedures were appropriate for the size and nature of the Funds. (Id.) Ellingsen also disputed Barron's finding that the audit team should have specifically evaluated the entity's procedures for prohibiting members of management from exercising significant influence over transactions in which that person is a related party. (Resp. Ex. 431A at 35.) He noted that it would not be unusual for Orecchio, as a fifty percent owner, to exercise influence, and that the Transfers were approved by Oliver, the other fifty percent owner. (Id.)

Ellingsen disputed Barron's opinion that the audit team ignored the risk associated with the Transfers being a "significant related-party transaction not in the ordinary course of business." (Id.) He opined that the Equity Fund's "transfer" of $1.9 million to AA Capital, if permitted under the Partnership Agreement, would not be outside the ordinary course of business. (Resp. Ex. 431A at 35; Tr. 1344.) Ellingsen also stated that with respect to the "transfer" from AA Capital to Orecchio, this transaction was in the ordinary course of business because "advances to owners in closely-held companies are common and ordinary." (Tr. 1345.) In addition, he noted that the typical reasons for examining related-party transactions more closely, such as concerns over meeting earnings forecasts or supporting the price of the company's stock, were not applicable at AA Capital. (Resp. Ex. 431A at 35-36.)

The audit team documented its review and understanding of AA Capital's internal controls in the ICFC and determined not to rely on internal controls, instead performing a substantive audit. (Resp. Ex. 431A at 39-40.) During audit planning, they established and documented quantitative materiality thresholds. (Resp. Ex. 431A at 40-41.) Ellingsen noted that the audit plan was documented in a 200-page checklist, which included specific procedures to be performed in each audit area, including cross-references to relevant workpapers. (Tr. 1258; Resp. Ex. 431A at 42.) In addition, the audit team prepared the ASM, which highlighted the audit plan and strategy to be implemented. (Tr. 1258-59; Resp. Ex. 431A at 42.)

With respect to supervision, Ellingsen testified that the audit workpapers contained evidence of Oprins' involvement in the planning process and his review of key audit areas. (Tr. 1272.) He found that in some cases, the engagement partner's review might consist solely of confirming that somebody else (e.g., an audit manager or senior) had reviewed that particular audit area. (Tr. 1273.) Ellingsen disagreed with Barron's assertion that Oprins, as engagement partner, is "responsible for all decisions made in the course of an engagement." (Resp. Ex. 431A at 45-46.) He also disagreed with Barron's conclusion that the time spent by Oprins was "wholly inadequate," noting that such a conclusion should not be made by comparing time spent to an average, or by comparing the time spent by the engagement partner to the total hours of the audit team.[46] (Resp. Ex. 431A at 46; Tr. 1273-74.)

b. Audit Work on the Transfers Complied with GAAS

Ellingsen noted that "transactions with related parties should not be assumed to be outside the ordinary course of business." (Resp. Ex. 431A at 55; Div. Ex. 99-L at 407, AU § 334.06; Tr. 1295.) He found that none of the factors that typically present a higher audit risk in connection with related-party transactions were present with respect to the Transfers. (Resp. Ex. 431A at 56.) Ellingsen opined that the audit team complied with the standards for auditing related-party transactions pursuant to AU § 334 (Resp. Ex. 431A at 62.) Those standards recommend audit procedures to (i) identify related parties, (ii) identify related-party transactions, (iii) understand the nature and purpose of any such transactions, and (iv) consider disclosures with respect to such transactions. (Resp. Ex. 431A at 57.) The auditor uses judgment in determining whether a particular audit procedure is required or appropriate. (Resp. Ex. 431A at 57; Div. Ex. 99-L at 405, AU § 334.01.) Ellingsen noted that the SEC did not allege any failure by Respondents to identify the related parties or related-party transactions. (Resp. Ex. 431A at 61; Tr. 1298-99.)

AU § 334 provides procedures that an auditor, in his judgment, should apply to understand related-party transactions and their effect on the financial statements. (Resp. Ex. 431A at 62; Tr. 1299.) The standards suggest that evidential matter be obtained in the following areas: (i) nature, terms and amounts of the transaction, (ii) business purpose of the transaction, (iii) documentation, (iv) approval of the transaction, and (v) collectability. (Resp. Ex. 431A at 63-64.) Ellingsen opined that the audit team obtained sufficient evidential matter regarding the nature, terms, and amount of the Transfers through review of client-prepared accounting documents (e.g., the Receivable Schedule) and inquiry of Stevens. (Resp. Ex. 431A at 65.) Through these procedures, the audit team learned that the Transfers represented a $1.92 million

[46] In Ellingsen's experience at Deloitte, he noted that the benchmark time cited for partner participation was closer to five percent, rather than the ten percent claimed by Barron. (Resp. Ex. 431A at 46.)

short-term advance made for the purpose of covering Orecchio's tax payments. (Resp. Ex. 431A at 65-66.) Ellingsen further noted that Stevens represented to McNeeley that the Transfers were made to Orecchio because of a mistaken tax liability relating to Orecchio's ownership interest in AA Capital. (Tr. 1415-16.)

According to Ellingsen, with respect to the payment from AA Capital to Orecchio, the auditors understood the business purpose of the transaction. (Resp. Ex. 431A at 67.) Ellingsen noted that even if the audit team had not learned of this specific reason for the Transfers, the AA Capital Shareholder's Agreement would permit the Transfers from AA Capital to Orecchio. (Id.) With respect to the payment from the Equity Fund to AA Capital, Ellingsen found the workpapers adequately described their understanding of the purpose behind the Transfers and that the Transfers were allowable under the Partnership Agreement. (Resp. Ex. 431A at 67-68.) Ellingsen referenced Section 7.3.3 of the Partnership Agreement, "Advances to Pay Estimated Taxes" and opined that, from an audit perspective, the audit team made a reasonable interpretation that the Partnership Agreement allowed the Transfers, therefore substantiating the transaction's legitimate business purpose. (Resp. Ex. 431A at 68-70.) He stated that it was not the auditor's role to make a legal interpretation of a provision within the Partnership Agreement. (Resp. Ex. 431A at 69.)

AU § 334 requires the auditor to obtain sufficient documentation to confirm his or her understanding of the transaction. (Resp. Ex. 431A at 70.) Ellingsen opined that the audit team acted reasonably in obtaining documentary evidence of the Transfers. (Resp. Ex. 431A at 72.) He noted that McNeeley had requested from Stevens "all documents related to the tax advances" and that this request was included on an "Open Items List" created during the audits. (Resp. Ex. 431A at 72.) Ellingsen noted that the audit team obtained the following documentation regarding the Transfers: (i) Receivable Spreadsheets; (ii) entity organization documents (e.g., the Partnership Agreement); (iii) bank statements (for vouching); (iv) management representation letters; and (v) Stevens' files concerning the Transfers (Stevens' Tax File). (Resp. Ex. 431A at 72-73.) Stevens' Tax File included numerous documents regarding the Transfers and Orecchio's tax obligation records. (Resp. Ex. 431A at 73.) Ellingsen disagreed with the SEC's position that the audit team failed to obtain documentation regarding Orecchio's purported tax liability. (Resp. Ex. 431A at 76.) He opined that Orecchio's use of the Transfers was not a related-party transaction for AA Capital or the Equity Fund, but rather a third-party transaction between Orecchio and the IRS. (Id.) According to Ellingsen, the auditors were not opining on, or required to gather information about Orecchio's transactions with the IRS.[47] (Id.)

Ellingsen stated that with respect to the "advances" from AA Capital to Orecchio, there is no doubt that Orecchio, as an owner and principal of AA Capital, and pursuant to AA Capital's by-laws, approved of the Transfers. (Resp. Ex. 431A at 76-77.) In addition, he opined that Oliver approved of the Transfers by virtue of his access, as co-owner and Treasurer of AA Capital, to the entity's books and records. (Resp. Ex. 431A at 77.) Oliver was also copied on an e-mail from Orecchio to Stevens requesting one of the "advances." (Resp. Ex. 431A at 78.)

[47] Ellingsen also opined that several of the procedures recommended by Barron are not directed at the Transfers, but instead are directed at Orecchio's transactions with the IRS. (Resp. Ex. 431A at 76.)

With regard to the "advances" from the Equity Fund to AA Capital, Ellingsen opined that McNeeley and Oprins acted reasonably in determining that the Partnership Agreement and provisions contained within the investment management agreements between the Equity Fund and AA Capital, and AA Capital and the Equity Fund's investors, provided broad authority to Orecchio to approve the Transfers. (Resp. Ex. 431A at 78-79.)

Ellingsen opined that the audit team obtained sufficient evidential matter regarding collectability of the Transfers. (Resp. Ex. 431A at 79.) With respect to "advances" made by the Equity Fund to AA Capital, E&Y, as auditor of AA Capital, understood that AA Capital had the financial ability to repay the "advances." (Resp. Ex. 431A at 80.) He also noted that AA Capital would be ill-advised to damage its relationship as investment adviser to the Equity Fund by failing to repay its debt, in addition to the Equity Fund's right to offset its management fees payable to AA Capital if the balance remained unpaid. (Id.) With regard to the collectability of the "advances" made from AA Capital to Orecchio, Ellingsen opined that the audit team reasonably relied on the value of Orecchio's ownership interest in AA Capital as sufficient to cover any default, as well as the likelihood that Orecchio, as a fifty percent owner of AA Capital, would not jeopardize its viability by defaulting on his financial obligation. (Resp. Ex. 431A at 80-81.)

c. Disclosure of the Transfers Complied with GAAP

i. The Equity Fund's Financial Statement Disclosure

Ellingsen opined that the Transfers, disclosed on the Equity Fund's balance sheet as a \$1.9 million "Accounts Receivable from AA Capital," complied with FAS 57. (Resp. Ex. 431A at 83.) He noted that under FAS 57, it is "material information," not simply "relevant or useful" information, that must be disclosed. (Tr. 1349-50.) According to Ellingsen, information is "material" if it would impact the decision of a reasonable user. (Tr. 1350.) The Equity Fund's footnote disclosure stated that AA Capital is responsible for the investment management of the fund. (Resp. Ex. 431A at 83.) Ellingsen stated that a reader of the financial statement would be informed that the Transfers were between two related parties, as well as the nature of the parties' relationship. (Id.) He stated that the amount of the Transfers was explicitly identified as "accounts receivable," which indicated that it was a short-term advance to be repaid within one year. (Id.)

Ellingsen disagreed with Barron that to comply with FAS 57, the disclosure was required to state when the Transfers were made to AA Capital, that AA Capital was going to advance the funds to Orecchio, and that Orecchio was going to use the funds to satisfy a purportedly erroneous tax liability. (Resp. Ex. 431A at 84.) According to Ellingsen, such detail involves a transaction "one or two steps removed" from the related-party transaction. (Id.) In Ellingsen's opinion, the purpose of the Transfers was clear; it was an advance, and what was done with the advance was not relevant to an understanding of the financial statements. (Tr. 1356.) He further stated that because investors in the Equity Fund received monthly reports describing capital calls "for a temporary tax distribution to the partners of AA Capital," additional disclosure concerning the Transfers would not have impacted a user's decision-making process. (Resp. Ex. 431A at 84-85; Tr. 1359-66.)

ii. AA Capital's Financial Statement Disclosure

According to Ellingsen, the Transfers were adequately disclosed on AA Capital's balance sheet as part of a $2.25 million asset titled "Accounts Receivable from Affiliates." (Resp. Ex. 431A at 85.) Ellingsen opined that although general purpose financial statements do not presume any particular users, actual and anticipated known users may influence an auditor's judgment about the extent of detail required in financial statement disclosures. (Id.) He stated that the known users of AA Capital's financial statements were the owners, Orecchio and Oliver, both of whom were aware of the Transfers. (Id.) There was no reasonable expectation that the financial statements would be used by anyone other than Orecchio and Oliver. (Resp. Ex. 431A at 85-86.) Ellingsen disagreed with Barron that in order for the financial statements to be presented fairly in conformity with GAAP, they were required to explicitly disclose the $1.9 million in "tax advances." (Resp. Ex. 431A at 87.) He stated that simply because Note 6 to AA Capital's financial statements disclosed a portion of the "Accounts Receivable from Affiliates" balance sheet item, this did not require additional disclosure of the Transfers. (Id.) Ellingsen stated that the disclosure was sufficient—it indicated that a party with a control relationship owed AA Capital money and that the transaction was a short-term advance to be repaid within one year. (Resp. Ex. 431A at 86.)

Ellingsen also opined that it was reasonable to include the $1.9 million related-party payable that AA Capital owed to the Equity Fund within the $2.5 million "Fee and accounts payable" line item on AA Capital's balance sheet. (Resp. Ex. 431A at 88.) He stated that the only material aspect of this related-party transaction was its amount, and that the nature of the payable, including to whom the payable was owed, was not material to the financial statements. (Id.)

3. Alan Funk

Respondents retained Alan Funk to opine on the effects of collusive fraud on an audit performed under GAAS (GAAS Audit) and the differences between a GAAS Audit and a forensic accounting examination.[48] (Resp. Ex. 431B at 2.) He did not opine on whether or not Respondents complied with auditing standards. (Tr. 1522.) Funk further testified that regardless of the existence of fraud or collusion, auditors may still violate the standards of GAAS or GAAP. (Tr. 1551.)

Funk opined that a GAAS audit is not the same as a forensic audit, which is designed to identify and quantify fraud. (Resp. Ex. 431B at 5.) He stated that while audit procedures may, under certain circumstances, detect certain kinds of fraud, they are not designed to and cannot detect all frauds, particularly those involving forgery and collusion. (Id.)

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[48] Funk, a CPA and certified fraud examiner, earned a degree in accounting from Brigham Young University. (Tr. 1479-80.) He has forty years of experience in public accounting, investigations, and litigation services, and has been employed as a financial auditor, a corporate controller, an FBI agent, the National Director of Fraud Investigative Services for a world-wide CPA firm, and a bankruptcy trustee, receiver, and examiner. (Resp. Ex. 431B at 2.)

According to Funk, collusion and fraud at AA Capital caused Orecchio's misappropriation of the Transfers to remain undetected by the auditors. (Resp. Ex. 431B at 9.) Funk's opinion is based on Stevens' representations, both orally and in writing, that the Transfers were made as a loan to enable Orecchio to pay estimated taxes to the IRS. (Resp. Ex. 431B at 12.) Funk stated that the evidence suggests Stevens was aware of Orecchio's misappropriation, but failed to tell the audit team about it. (Id.) Funk offered no opinion as to the point at which, if any, Stevens began to collude with Orecchio regarding the purported "tax liabilities" or whether, at any point, Stevens, herself, could have been misled by Orecchio. (Tr. 1641-42.) Funk also based his opinion on the fact that Orecchio was willing to forge and alter documentation regarding his purported tax liability.[49] (Resp. Ex. 431A at 11.) Funk acknowledged that there was no evidence indicating that the audit team received this documentation or included it in its audit workpapers. (Tr. 1501-02.)

Funk opined that the fraudulent activity at AA Capital was exactly the kind of collusive fraud most difficult to detect through normal audit procedures. (Resp. Ex. 431B at 12.) He supported his opinion by describing a $950,000 consulting agreement and invoice with "DG Consulting" dated June 30, 2003, and January 13, 2004, respectively. (Resp. Ex. 431B at 13.) It was later determined that the consulting agreement and invoice were the result of collusive fraud or forgery.[50] (Id.) Funk also pointed to Stevens' acquiescence in wiring investor funds to Orecchio without adequate documentation. (Resp. Ex. 431B at 14.) Funk cited several examples of e-mails between Stevens and Orecchio discussing Orecchio's wire transfer requests, and in some cases, Stevens' concern about the amounts and purposes of the transfers. (Resp. Ex. 431B at 14-15.) According to Funk, the e-mails indicate that Orecchio and Stevens conspired to hide Orecchio's alleged misappropriations from the audit team. (Resp. Ex. 431B at 16.)

Funk also opined that many of the audit procedures suggested by the Division and its expert witness, Barron, are procedures appropriate for a forensic examination, not a GAAS audit. (Resp. Ex. 431B at 18.) According to Funk, for example, reviewing IRS forms or correspondence evidencing Orecchio's alleged tax obligations is a procedure more appropriately performed as part of a forensic examination. (Resp. Ex. 431B at 18-19.)

III. CONCLUSIONS OF LAW

Rule 102(e) permits the Commission to censure or deny, permanently or temporarily, the privilege of appearing or practicing before it to persons found to have engaged in improper professional conduct. Respondents were charged, pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(ii), with improper professional conduct stemming from alleged improper practices in the 2004 audits of AA Capital and the

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[49] Funk described two forged letters purportedly from the IRS discussing Orecchio's multi-million dollar tax liability. (Resp. Ex. 431B at 11.) Metadata associated with one document dated March 18, 2005, revealed that it was created by Orecchio. (Id.)

[50] Funk also described the receipt of a false confirmation of an investment by AA Capital in AART Development during the audit of AA Capital for the year ended December 31, 2005. (Resp. Ex. 431B at 13.)

Equity Fund, specifically, with respect to the audit procedures performed on the Transfers and related financial statement disclosures.

A. Rule 102(e)

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

> With respect to accountants, "improper professional conduct" includes:
> (A) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
>
> (B) . . . negligent conduct [consisting of]:
>
> (1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

Rule 102(e)(1)(iv), 17 C.F.R. § 201.102(e)(1)(iv).

1. Reckless Conduct

The Commission defines recklessness under Rule 102(e) to be the same as recklessness under the antifraud provisions. Amendment to Rule 102(e) of the Commission's Rules of Practice, 63 Fed. Reg. 57164, 57167 (Oct. 26, 1998) (Rule 102(e) Amendment). Thus, to establish that Respondents' conduct was reckless, the Division must show an '"extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it.'" Id. (quoting SEC v. Steadman, 967 F.2d 656, 641 (D.C. Cir. 1992)). It is "a lesser form of intent, . . . not merely a heightened form of ordinary negligence." Id. "The Commission does not consider the subjective good faith of an accountant to be an absolute defense under Rule 102(e)(1)(ii). Id. at 57170. Subjective good faith is inconsistent with a finding of knowing or intentional, including reckless, conduct." Id.

Recklessness is more than a misapplication of accounting principles. SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992). The Division must prove that Respondents' "accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments . . . were such that no reasonable accountant would have made the same decision if confronted with the same facts." Id. Violations of GAAP or GAAS in themselves do not constitute recklessness. See Chill v. General Elec. Co., 101 F.3d 263, 270 (2d Cir. 1996) ("Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient."). An auditor's conduct is reckless when he or she skips procedures designed to discover material misstatements or looks the other way despite suspicions. See Marrie v. SEC, 374 F.3d 1196, 1204 (D.C. Cir. 2004).

There is no evidence in the record to support fraudulent intent or bad faith on the part of Respondents. Notwithstanding serious deficiencies in the procedures performed on the Transfers, discussed infra, there is no evidence to support a finding that "the audit amounted to no audit at all." Moreover, the Division's expert testified that reasonable accountants could disagree about whether there was a violation of the auditing standards. (Tr. 1079.) I conclude that Respondents' conduct was not reckless within the meaning of Commission Rule of Practice 102(e)(1)(iv)(A).

2. Negligent Conduct

"Highly unreasonable" conduct was first defined in the Rule 102(e) Amendment as a new concept. 63 Fed. Reg. at 57167-68. It is higher than ordinary negligence, but lower than recklessness. Id. at 57167. It is measured by the degree of departure from professional standards and not the intent of the accountant. Id. It is not judged by hindsight, but compares actions taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken. Id. at 57168. A single instance of highly unreasonable conduct when an accountant knows, or should know, that heightened scrutiny is warranted conclusively demonstrates a lack of competence to practice before the Commission. Id. at 57164. A single judgment error, even if unreasonable when made, may not indicate a lack of competence to practice before the Commission and not pose a future threat to the Commission's processes requiring Commission action. Id. at 57166 & n.28, 57167.

3. Applicable Professional Standards

The "applicable professional standards" for accountants include GAAS, GAAP, the AICPA Code of Professional Conduct, and Commission regulations; it encompasses "the body of professional guidance routinely used by accountants." Id. at 57166. As with determining negligent conduct, the standards must not be evaluated with the benefit of hindsight, but on what the accountant knew or should have known at the time the action or decision was made. Id. at 57168. The ten basic GAAS standards include three General Standards, three Standards of Fieldwork and four Reporting Standards. (Div. Ex. 98 at 3.) At issue in this proceeding are the third General Standard (Due Professional Care); the first and third Standards of Fieldwork (Adequate Supervision and Sufficient Competent Evidential Matter, respectively); the first Reporting Standard (Financial Statements in Accordance with GAAP); and a number of AU Sections, discussed infra.

Thus, to conclude that Respondents engaged in improper professional conduct within the meaning of Rule 102(e), it is necessary to conclude, first, that they violated GAAS and/or GAAP, and second, that the GAAS and/or GAAP violation[s] resulted from a single instance of highly unreasonable conduct in circumstances in which Respondents knew, or should have known, that heightened scrutiny was warranted.

B. McNeeley Violated GAAS

1. McNeeley Failed to Obtain Sufficient Competent Evidential Matter on the Transfers

GAAS requires auditors to obtain competent evidential matter in order to form a reasonable basis for an audit opinion. (Div. Ex. 99-J at 289, AU § 326.01.) GAAS expressly states that representations of management "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." (Div. Ex. 99-K at 365, AU § 333.02.) Auditors must not be satisfied with audit evidence that is not persuasive, or with less-than-persuasive evidence because of a belief that management is honest. (Div. Ex. 99-I at 129, 132, AU § 316.03, .13.)

GAAS also provides specific guidance regarding related-party transactions, such as the Transfers. In applying procedures to obtain satisfaction concerning the "purpose, nature, and extent of these transactions and their effect on the financial statements," which should extend beyond inquiry of management, the auditor should consider "examin[ing] invoices, executed copies of agreements, contracts, and other pertinent documents . . . ," as well as "inspect[ing] evidence in possession of the other party or parties to the transaction."[51] (AU § 334.09, .10.) The standards suggest that evidential matter be obtained in the following areas: (i) nature, terms and amounts of the transaction; (ii) business purpose; (iii) documentation; (iv) approval; and (v) collectability. The core of this proceeding involves the third prong, sufficient documentation.[52]

To obtain "sufficient competent evidential matter" regarding the Transfers, a material, related-party transaction, the audit team (i) obtained and reviewed the Receivable Schedule, and (ii) obtained and documented McNeeley's understanding of the Transfers pursuant to her conversations and e-mail exchanges with Stevens (McNeeley's Note). Barron opined, and the record reflects, that these two procedures were the primary documentary evidence included in the workpapers supporting the Transfers. However, the Receivable Schedule and McNeeley's Note were essentially inquiries of management and insufficient under GAAS.

a. The Receivable Schedule

Using the Receivable Schedule, a staff auditor identified the amounts comprising the Transfers as a related-party transaction and brought the issue to McNeeley's attention for further consideration. Therefore, review of the Receivable Schedule was the starting point for identifying the related party and amounts involved, rather than a procedure designed to confirm the legitimacy of the Transfers. Moreover, the Receivable Schedule did not offer real audit assurance because it was prepared by AA Capital, a company whose internal controls were deemed unreliable by the audit team. The Receivable Schedule also documented the audit

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[51] Respondents emphasize that such procedures are not required, but instead are within an auditor's professional judgment.

[52] McNeeley documented in the workpapers her understanding of the nature, terms and amount of the Transfers, as well as its business purpose. Ellingsen opined that the audit team reasonably considered the approval and collectability of the Transfers. Because no evidence of approval or collectability was documented in the audit workpapers, I do not credit Ellingsen's testimony.

team's vouching of cash disbursements to and from the bank statements and Orecchio. However, while vouching confirmed the amount of money paid to Orecchio, it did not verify the legitimacy of the Transfers. The audit team also vouched disbursements to supporting invoices; however, none of the material related-party payments comprising the Transfers were selected for vouching and traced to supporting documentation, such as correspondence or payments between Orecchio and the IRS.

b. McNeeley's Note

McNeeley's Note documented that the Equity Fund had made $1.92 million of tax payments for Orecchio and that the flow of money between the Equity Fund, AA Capital, and Orecchio was accounted for properly on their respective financial statements. Based on her understanding, McNeeley concluded "appears proper." However, her conclusion was based largely on Stevens' representation. McNeeley's Note also omitted a critical piece of information—according to Stevens, the Transfers were made to pay an erroneous tax assessment and could not be settled until the audit and tax work was completed.

c. The Partnership Agreement

Respondents contend that they performed several other audit procedures on the Transfers that provided "sufficient competent evidential matter." Most notably, McNeeley stated that she reviewed the Partnership Agreement and determined that the Transfers were permitted as a "tax advance" pursuant to Section 7.3.3.[53] McNeeley testified that she reviewed the Partnership Agreement at the beginning of the audit, but could not recall if she went back and specifically reviewed its provisions in connection with her analysis of the Transfers. There is no evidence that McNeeley documented her review of the Partnership Agreement, despite its importance as audit evidence.[54] I find the absence of such documentation persuasive evidence that McNeeley did not review the Partnership Agreement specifically in connection with her review of the Transfers. While McNeeley was not required under GAAS to obtain a legal interpretation, I find that it was unreasonable for McNeeley to rely on her memory in evaluating the permissibility of the Transfers.[55]

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[53] Ellingsen agreed with Respondents' interpretation of the Partnership Agreement.

[54] Barron opined that given the nature and size of the related-party transaction, the documentation in the audit workpapers should reflect all of the relevant audit procedures that formed the basis for the auditors' conclusions with respect to the Transfers. McNeeley acknowledged that the Partnership Agreement was "perhaps the most important piece of audit evidence" she had regarding the Transfers. (McNeeley Reply Br. 5.) Both Barron and Ellingsen testified regarding the importance of the Partnership Agreement. Barron acknowledged that a "sufficient understanding" that the Partnership Agreement allowed for tax advances of this kind and that the amount of the advance was reasonable would, in his opinion, have been "sufficient audit evidence." Ellingsen opined that the Equity Fund's "transfer" of $1.9 million to AA Capital, if permitted under the Partnership Agreement, would not be "outside the ordinary course of business."

[55] McNeeley testified that she was generally familiar with partnership agreements for private equity clients.

The terms of the Partnership Agreement's Tax Distribution and Tax Advance provisions were complex. An analysis of the Partnership Agreement's provisions should have raised serious concerns regarding the permissibility of a "tax advance" to pay a disputed or erroneous tax liability. Section 7.3.1 of the Partnership Agreement provides that *if* net income of the Partnership is allocated to the Partners in any fiscal year, *then* the partnership may make "tax distributions" to satisfy a partner's *actual* aggregate tax liabilities. Section 7.3.3, which is subject to Section 7.3.1, provided for advances to partners for the purpose of satisfying estimated (actual) taxes. However, the Equity Fund had a net investment loss in 2003 and 2004. Therefore, without income to allocate, it appears there was no reasonable basis to conclude that the Transfers were permissible under the Partnership Agreement. Even if the Partnership Agreement permitted the Transfers, a detailed analysis, documented in the audit workpapers, would have been required.

d. Other Audit Evidence

McNeeley points to the general ledger, which included entries showing the amounts, dates, and nature of the Transfers, as providing additional independent audit evidence. Because both the Receivable Schedule and general ledger contain the same information[56] and were both prepared by Stevens, I find review of the general ledger is not persuasive independent audit evidence. McNeeley also contends that AA Capital's and the Equity Fund's management representation letters were additional audit evidence. However, I credit Barron's testimony that the management representation letters are simply another form of management inquiry pertaining to the Transfers. McNeeley relied on boilerplate disclosures, notwithstanding that other related-party provisions within the management representation letters (not at issue in this proceeding) contained customized representations. If the audit team intended to rely upon the management representation letters as persuasive audit evidence with respect to the Transfers, they would have customized the representation, particularly in light of the limited evidence the audit team was provided.[57]

McNeeley failed to obtain other audit evidence which should have been readily available, including (i) third-party documentation of Orecchio's purported tax liability and payments; (ii) Orecchio's ability to repay the loan; (iii) Orecchio's partnership capital balance in the Equity Fund, in relation to the Transfers; and (iv) Orecchio's personal tax situation, including discussions with Orecchio personally.[58] Aquino possessed the same "audit evidence" McNeeley

[56] McNeeley testified that the Receivable Schedule was a detailed listing of account balances and transactions that are recorded in the general ledger.
[57] Ellingsen testified that the audit team also obtained Stevens' Tax File, which included numerous documents regarding the Transfers and Orecchio's tax obligation records. However, no evidence was produced that the audit team ever obtained or reviewed Stevens' Tax File in connection with the 2004 Audit.
[58] Ellingsen testified that Orecchio's transactions with the IRS were separate and distinct from the Transfers at issue in this proceeding. According to Ellingsen, E&Y was not engaged to opine on, or required to gather evidence about, Orecchio's transactions with the IRS. I do not credit Ellingsen's opinion; the business purpose for the Transfers was clearly relevant in auditing the Transfers.

had during the 2004 Audit, but testified that without documentation, "the [audit team] didn't have anything to audit." Moreover, key issues raised during the 2005 audit, including whether the Transfers were authorized under the relevant corporate documents, and whether the Transfers were a breach of fiduciary duty, were not raised during the 2004 Audit, even though the Transfers were a material related-party transaction during both the 2004 and 2005 audits.[59]

e. The Alleged Effect of Collusion on the 2004 Audit

McNeeley contends that the audit was interfered with by a "coordinated, criminal, and ultimately successful effort to deceive the auditors," including the offering of false and forged documents. (McNeeley Br. 25.) Respondents' expert, Funk, opined on the effects of collusive fraud on an audit and the differences between a GAAS audit and a forensic examination. He did not opine on whether or not Respondents complied with the auditing standards at issue in this proceeding.

I do not credit Funk's opinion that collusion and fraud at AA Capital caused Orecchio's misappropriation to remain undetected by the auditors. There is no evidence that the auditors were provided with, or relied upon, fake or forged documentary evidence relevant to the Transfers during the 2004 Audit. The evidence credited by Funk in support of his opinion fell outside the 2004 Audit period or had nothing to do with the audit team's work on the Transfers. In fact, Funk offered no opinion as to when, if ever, Stevens colluded with Orecchio, or whether Stevens, herself, could have been misled by Orecchio.[60] I credit Barron's opinion that with regard to the Transfers, the audit team did not receive or rely upon evidence that appeared to be persuasive, but was not, due to fraud.

2. McNeeley Failed to Exercise Due Care in Evaluating the Transfers

Auditors are required to exercise due professional care in the planning and performance of an audit. (Div. Ex. 99-F at 43, AU § 230.01.) Due professional care requires the auditor to exercise professional skepticism, defined as an attitude that "includes a questioning mind and a critical assessment of audit evidence." (Div. Ex. 99-F at 44, AU § 230.07.) When exercising due care, an auditor is not to assume that management is dishonest nor assume unquestioned honesty. (Div. Ex. 99-F at 44, AU § 230.09.) McNeeley failed to exercise professional skepticism and make further inquiries despite multiple indications that the Transfers warranted heightened scrutiny.

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[59] Barron suggested a number of other additional procedures that the audit team could have performed until it became satisfied that it had persuasive audit evidence supporting the Transfers: consulting Orecchio; speaking with E&Y's tax department responsible for the AA Capital account; consulting an attorney with respect to the Partnership Agreement; and performing analytical procedures. Contrary to Respondents' contention, Barron offered these additional procedures, not as requirements under the professional standards, but as examples of alternative procedures that were available to the audit team to obtain "sufficient competent evidential matter."

[60] The record contains evidence of e-mail correspondence between Stevens and Orecchio regarding his tax liabilities. <u>See</u> n.16, <u>supra</u>.

a. The Transfers Were Not Within the Ordinary Course of Business

I credit Barron's testimony that the Transfers were not "within the ordinary course of business" for AA Capital for several reasons: (i) the Transfers were funded from the Investor Trust Accounts, rather than Orecchio's capital balance;[61] (ii) Orecchio's capital balance was grossly insufficient to cover the amount of the Transfers;[62] and (iii) the Transfers were described by Stevens as being made for the purpose of paying an erroneous tax liability.[63]

b. Other Discrepancies Should Have Raised Questions

McNeeley failed to investigate other discrepancies with respect to the Transfers. The audit team received two different explanations for the Transfers. Rojas documented on the Receivable Schedule her understanding from Stevens that the Transfers were made to Orecchio because all of the Funds held under AA Capital had not finalized their audits and tax filings, and therefore Orecchio had to estimate his tax liability and pay the IRS $1,921,150. But McNeeley later learned from Stevens that the Transfers were for Orecchio to pay an erroneous tax liability. Rojas' explanation that "all of the Funds held under AA Capital had not finalized their audits" was also inconsistent with the Equity Fund being the only Fund from which withdrawals were made for the Transfers.

The audit team failed to correlate the Transfers with Orecchio's actual tax liability and investigate why Orecchio's and Oliver's "tax distributions" were so different.[64] Notwithstanding Stevens' characterization of the liability as erroneous, McNeeley had a responsibility to assess the reasonableness of the Transfers. If she could not assess the reasonableness of Orecchio's "distribution" compared to Oliver, she should have obtained additional persuasive evidence.

McNeeley testified that she could not recall receiving specific documentation in response to her request for "any and all documentation that [Stevens] had regarding the tax advances." I find that McNeeley's request supports an inference that if the Transfers were for tax payments, she expected that Stevens could provide a cancelled check, IRS correspondence, or some other documentary evidence supporting the payments. Professional skepticism required her to investigate further.

Respondents note that Stevens repeatedly complained to Orecchio that the auditors were very persistent and asked her for documentary support multiple times. They contend this is

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[61] The Partnership Agreement used the term "distributions," but distributions are normally paid out of accumulated earnings, such as partner's capital.

[62] Barron testified that Orecchio's capital balance in the Equity Fund would have been approximately $250,000. (Div. Ex. 98 at 41; Tr. 927.)

[63] Respondents point to the testimony of Haas in support of their contention that a million dollar erroneous tax assessment is not unusual in context of private equity funds. However, the audit team never consulted Haas during the 2004 Audit.

[64] McNeeley was responsible for assessing the collectability of the receivable, a task impossible to perform when she failed to determine what portion, if any, of the Transfers related to Orecchio's actual tax liability.

evidence of the audit team's diligence. (Oprins Br. 18.) But diligence alone does not provide competent evidential matter; if anything, such efforts show the importance the audit team placed on obtaining additional audit evidence to support the Transfers. The unresolved issues and discrepancies should have prompted McNeeley to raise the issue with Oprins during the audit, or include some discussion of the Transfers in the SRM. As a result of her omissions, McNeeley deprived both Oprins and Kavanaugh of the opportunity to perform a meaningful independent review.

c. Subsequent Review Testing

McNeeley signed off on an audit checklist as having performed subsequent review testing. The procedure indicated that disbursements during the period January 1, 2005, through March 31, 2005, were reviewed for significant unusual items that might relate back to the period under audit at December 31, 2004. A review of AA Capital's 2005 accounts receivable schedule showed that AA Capital made nine additional disbursements to Orecchio totaling $482,000, described as "J.O. taxes," "JO Tax Distrib," or "JO Tax Dist."[65] Many of the individual disbursements were material, including a February 22, 2005, disbursement in the amount of $266,000. There is no evidence that McNeeley made any inquiry following her discovery that the Transfers had grown from $1.92 million to $2.4 million in the three months following the 2004 Audit.

C. <u>McNeeley and Oprins Violated GAAP</u>

FAS 57 governs the disclosure of the Transfers in AA Capital's and the Equity Fund's financial statements. The Division's core argument is that AA Capital's and the Equity Fund's disclosures failed to describe adequately the Transfers and such other information necessary to understand the effects of the transactions on the financial statements.[66] Barron testified that "understanding the effects of the transactions on the financial statements" should be construed broadly to include the importance of the disclosure to the financial statement users. "[I]nformation about transactions with related parties that would make a difference in decisionmaking should be disclosed so that users of the financial statements can evaluate their significance." (Div. Ex. 99-A at FAS57-5, FAS 57 ¶18.) In addition, "[g]enerally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. The auditor should consider whether the substance of transactions or events differs materially from their form." (Div. Ex. 99-M at 561, AU § 411.06.)

Ellingsen suggested a more narrow construction that would bifurcate the Transfers into two distinct categories: (i) related-party transactions in which money was advanced from the Equity Fund to AA Capital, and again from AA Capital to Orecchio; and (ii) a third-party transaction between Orecchio and the IRS. According to Ellingsen, the details of the third-party

[65]The accounts receivable schedule was included in the 2005 audit workpapers; it was not included in the 2004 workpapers as support for the audit team's subsequent review testing.
[66] FAS 57 also requires that financial statements disclose the nature of the relationships involved, the total dollar amount of the transactions, and the amounts due from or to any related parties and, if not otherwise apparent, the terms and manner of settlement.

transaction were "one or two steps removed" from the related-party transactions and not required to be disclosed. However, I credit Barron's interpretation of FAS 57 and its requirements, and reject the distinction offered by Ellingsen.[67]

1. The Equity Fund

The Equity Fund's financial statements disclosed the Transfers as an "Accounts receivable from AA Capital," despite the fact that the audit team believed the Transfers were essentially a loan to an officer of the company. But, "accounts receivable" arise in the ordinary course of business, and as discussed supra, I find that the Transfers were not a transaction arising in the ordinary course of business. A reader of the Equity Fund's 2004 financial statements would have no way of knowing that the Equity Fund loaned $1.92 million to AA Capital for the ultimate purpose of paying a personal and erroneous tax liability of a company officer. I find Barron's testimony persuasive—without such disclosure, a user of the financial statements would not be able to understand the significance of that line item and make a determination whether the related-party transaction should be a cause for concern. An interpretation permitting such limited disclosure would obviate the need for FAS 57. Knowledge that funds were withdrawn from the Equity Fund's Investor Trust Accounts to pay a purportedly erroneous tax liability of an officer would certainly make a difference in the decisionmaking of a user or potential user of the Equity Fund's financial statements.[68]

2. AA Capital

AA Capital's 2004 financial statements reported the Transfers as both "Fee and accounts payable," reflecting the monies received from the Equity Fund, and as "Accounts receivable from affiliates," reflecting the payment to Orecchio. The $1.92 million was only part of the balances reflected in both line items, making it impossible for a user to determine that the receivable and payable amounts were related. Moreover, the payable to the Equity Fund was lumped together in a single line item without any indication that it was owed to a related party.

The disclosure here suffers from the same flaws discussed above. The limited disclosure hid the true substance of the Transfers and would mislead a user into believing that the Transfers

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[67] Ellingsen distinguishes the "transfer" from the Equity Fund to AA Capital, apart from the "transfer" from AA Capital to Orecchio, to provide evidence that that audit work complied with GAAS. See supra, Part II.D.2.b. I find Ellingsen's "form over substance" argument unpersuasive.

[68] Respondents contend that the investors in the Equity Fund could not have been misled by the disclosure because the Transfers were disclosed in monthly statements sent to the investors. Respondents' argument is unpersuasive because it does not account for the potential users of the Equity Fund's financial statements, nor did the disclosure specify that the distribution was for the purpose of paying an erroneous tax liability. Potential investors would not have been privy to the monthly reporting statements. Moreover, to the extent Respondents relied upon their belief that the Equity Fund's financial statements would only be used by current investors, the auditors should have issued a "restricted use" audit report.

arose in the ordinary course of business.[69] The audit team also failed to follow its own internal GAAP Disclosure Checklist, which noted that financial statements should "state separately amounts receivable (at net realizable value) from . . . [d]irectors and officers." (Div. Reply Br. 23.) In response to this item, McNeeley indicated "not applicable." Oprins also reviewed this checklist. Respondents contend that because AA Capital's two owners were both aware of the "advance," and that no other reader of the financial statements was misled by them, additional disclosure was not required. However, I am not persuaded by this argument because the financial statements were not designated as "restricted use."[70]

McNeeley and Oprins permitted disclosures that may have depicted accurately the form of the Transfers, i.e., the flow of money to and from the Funds, but the disclosure failed to reflect the substance, which was allegedly to enable Orecchio to pay a personal tax liability assessed against him in error. Therefore, both Respondents failed to ensure that AA Capital's and the Equity Fund's financial statements disclosed the Transfers in accordance with GAAP and FAS 57.

D. The Circumstances Warranted Heightened Scrutiny

Courts and the Commission have recognized that material related-party transactions warrant heightened scrutiny. See McCurdy v. SEC, 396 F.3d 1258, 1261 (D.C. Cir. 2005) (acknowledging that because an auditor cannot fully scrutinize each and every transaction, certain transactions, including related-party transactions, require closer inspection). Moreover, the Transfers were outside of the normal course of business, and unusual in terms of their size, structure, and purported purpose. The $1.92 million in Transfers were quantitatively material to the Funds.[71] The two-stage process by which funds were ultimately withdrawn from the Investor Trust Accounts and paid to Orecchio helped disguise the true nature of the Transfers. McNeeley should have recognized this as an area for investigation, evidenced by her own difficulty understanding the transaction.

Moreover, McNeeley had two significant indications that heightened scrutiny was warranted: (i) a failure by Stevens to provide documentation supporting the Transfers, despite multiple requests; and (ii) knowledge obtained during the subsequent review testing that an additional $482,000 had been paid to Orecchio as additional "Transfers." The totality of the circumstances required that McNeeley apply heightened scrutiny to the Transfers.

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[69] Notably, AA Capital's 2004 financial statements included a Note that provided details regarding certain of its related-party transactions, but not with respect to the $1.92 million Transfer.

[70] Ellingsen opined that the actual and anticipated known users may influence an auditor's judgment about the extent of detail required to be disclosed. Arguably, there may have been no anticipated users for AA Capital's financial statements. However, the same cannot be said with respect to potential investors in the Equity Fund.

[71] Respondents point to the testimony of Haas, who stated that in this context, "a million dollars is peanuts." However, the audit team never consulted Haas during the 2004 Audit and thus could not have relied upon his opinion.

E. McNeeley's Conduct Was Highly Unreasonable

The record fails to establish that McNeeley acted in bad faith, "egregiously refused to see the obvious," or failed to perform "any audit at all" with respect to the Transfers. However, I find that the sum of her actions, or inaction, go beyond ordinary negligence.

McNeeley's conduct was highly unreasonable in circumstances warranting heightened scrutiny for the following reasons: (i) she failed to resolve her open-item request that Stevens provide documentary evidence supporting the Transfers; (ii) she failed to obtain independent third-party evidence supporting the Transfers, such as a cancelled check or correspondence between Orecchio and the IRS, instead relying on management-prepared documents and representations; (iii) she acknowledged the importance of the Partnership Agreement as audit evidence, but failed to review the tax distribution provisions specifically in connection with the Transfers, instead relying on her memory, and failed to document her analysis in the workpapers; (iv) she learned that the Transfers had increased by $482,000 shortly after the 2004 year end and failed to investigate; (v) she failed to fully inform Oprins of the circumstances surrounding the Transfers, effectively preventing him from performing his review function as the engagement partner; and (vi) she failed to require the Transfers be disclosed in accordance with GAAP.

F. Oprins' Conduct Was Not Highly Unreasonable

1. Oprins Adequately Planned and Reasonably Supervised the 2004 Audit

GAAS requires audit work to be adequately planned and assistants,[72] if any, to be properly supervised. (Div. Ex. 99-G at 71, AU § 311.01.) "Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing work performed, and dealing with differences of opinion among firm personnel." (Div. Ex. 99-G at 74, AU § 311.11.)

The Division argued that the 2004 Audit was not adequately planned, citing, for example, correspondence between McNeeley and Oprins regarding staffing issues. The Division also alleged that the audit team failed to assess properly the risks typically associated with a small client, including a lack of segregation of duties, and the absence of procedures to monitor and/or limit the influence of management over transactions. I find the audit team, including Oprins, adequately planned the 2004 Audit. They acted reasonably in addressing and resolving the staffing issues, and reasonably determined not to rely on internal controls, which had the effect of addressing many of the issues raised by the Division that are common in audits of closely-held companies. Although the Division's expert opined that the small amount of time Oprins spent on the 2004 Audit indicated a failure to properly supervise, I find Oprins' time spent on the 2004 Audit to be reasonable.

Oprins read McNeeley's Note and learned of the Transfers during the 2004 Audit. However, the record does not establish that Oprins was ever made aware that the Transfers were purportedly made to satisfy an erroneous tax liability. McNeeley's Note omitted any reference

[72] For purposes of AU § 311, McNeeley was an "assistant." (Div. Ex. 99-G at 71, AU § 331.02.)

to her understanding from Stevens that "most of the [tax payments] were not correct." Thus, McNeeley failed to inform the engagement partner of an extremely significant characteristic of Transfers—one that would likely cause a reasonable auditor to deem the Transfers a transaction "outside the course of ordinary business," or at least raise fiduciary duty concerns.

Moreover, after receiving no documentary support from Stevens despite numerous requests, McNeeley failed to bring the issue to Oprins' attention. McNeeley never discussed the Transfers with Oprins during the audit, nor did she reference the Transfers in the SRM. The purpose of the SRM was to highlight key issues for consideration by senior management not involved in the day-to-day audit fieldwork. By not discussing the Transfers with Oprins, or highlighting the Transfers in the SRM, McNeeley again deprived Oprins of full information.

Oprins testified that McNeeley's Note did not raise any "red flags" for him. I find his testimony credible, based on McNeeley's significant omissions and Oprins' knowledge that AA Capital and its principals had experienced tax delinquency assessments in the past. If anything, McNeeley's Note had a "lulling effect" on him. As the engagement partner, Oprins reasonably relied on McNeeley, a highly regarded auditor, to perform the audit in accordance with professional standards and escalate issues, such as the Transfers, to his attention.[73] I therefore find that Oprins acted reasonably in supervising the 2004 Audit.

2. Oprins' Failure to Ensure the Transfers Were Disclosed in Accordance with GAAP Was Not Highly Unreasonable

Oprins knew that FAS 57 required disclosing material related-party transactions and he should have questioned the failure to describe the purpose of the Transfers. He also failed to adhere to E&Y's GAAP Disclosure Checklist, which advised the audit team that receivables from officers should be stated separately in the financial statements. Oprins acknowledged that disclosure of the Transfers was not as good as it could have been, but believed that it met the minimum requirements under GAAP. I conclude that Oprins violated GAAP by failing to ensure that AA Capital's and the Equity Fund's financial statements disclosed the purpose and substance behind the Transfers, in accordance with FAS 57. However, because of the professional judgment involved in evaluating financial statement disclosure, as well as interpreting FAS 57, I conclude that Oprins' conduct, while unreasonable, does not rise to the level of highly unreasonable conduct, as required under Rule 102(e).[74] Therefore, because I find that Oprins reasonably supervised the 2004 Audit, and did not act highly unreasonably with respect to the GAAP violation, this proceeding as to Oprins shall be dismissed.

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[73] McNeeley had excellent credentials, was well regarded, and advanced quickly in her career. (Tr. 39.) Kavanaugh also testified that in his experience, McNeeley was a very competent and diligent auditor. (Tr. 775.)

[74] Barron and Ellingsen interpreted FAS 57's requirements differently. Moreover, the issue in this proceeding was not a complete failure to disclose, but rather the extent of disclosure required using professional judgment. In addition, Kavanaugh opined that the disclosure satisfied GAAP. While the Division discounts Kavanaugh's opinion as self-serving given his employment with E&Y and involvement in the AA Capital audits, I find his testimony informative as it relates to the reasonableness of Oprins' conduct.

IV. SANCTIONS

The Division requests that Respondents be barred from appearing or practicing before the Commission as accountants for a period of three years. (Div. Br. 47.) The Commission may impose a censure or deny a person the privilege to practice before it, temporarily or permanently. 17 C.F.R. § 201.102(e)(1). Sanctions under Rule 102(e) may be imposed for remedial purposes only. McCurdy, 396 F.3d at 1264; Johnson v. SEC, 87 F.3d 484, 490 (D.C. Cir. 1996). The purpose of Rule 102 sanctions is not to punish, but to protect the public from future reckless or negligent conduct by professionals who practice before the Commission. 17 C.F.R. § 201.102(e)(1)(iv); McCurdy, 396 F.3d at 1264-65. Sanctions under Rule 102(e), as applied to accountants, encourage a more rigorous compliance with GAAS in future audits. McCurdy, 396 F.3d at 1265.

Wendy McNeeley

McNeeley, 34 years old, is a licensed CPA. She has spent the majority of her career working for two national accounting firms, performing audits of financial services firms, or performing technical reviews of the financial statements for financial services firms. McNeeley is currently employed in the accounting field and intends to continue in that capacity.

McNeeley, as the audit manager, was primarily responsible for ensuring the 2004 Audit complied with GAAS and the financial statements complied with GAAP. McNeeley's failures were significant. She missed significant warning signs throughout the audit, not the least of which was the increase in the Transfers balance that should have been discovered during the subsequent review testing and investigated. She failed to follow up on her request of Stevens to provide documentary support for the Transfers. And she failed to ensure that the Transfers were disclosed in the financial statements in accordance with GAAP and FAS 57.

Notwithstanding her failures, the record contains evidence that I believe lowers the risk that McNeeley will commit future violations of the professional standards applicable to accountants, and therefore supports a sanction less severe than that requested by the Division. This proceeding is focused upon a narrow issue, involving one transaction among many, during a series of ten audits conducted simultaneously; the OIP did not allege any deficiencies except with respect to the Transfers. The Transfers were not part of a key audit area typically focused on in audits of private equity funds; the audit team reasonably focused its attention on a number of higher-priority audit areas. The Transfers did not raise the types of concerns typically associated with related-party transactions, such as artificially inflating the profit or loss of the entity. I also find Respondents reasonably planned the AA Capital engagement and had no indication that AA Capital would be a risky client.[75] But cf. Gregory M. Dearlove, 92 SEC Docket 1867, 1871-72 (Jan. 31, 2008); Barry C. Scutillo, 56 S.E.C. 714, 717 (2003). Regarding the GAAP violation, the issue was not the complete omission of disclosure, but rather the extent of disclosure required using professional judgment. Finally, McNeeley has had a distinguished career and no disciplinary history.

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[75] The principals and key personnel at AA Capital had distinguished educational and professional backgrounds.

I find that in light of the totality of McNeeley's conduct with respect to the Transfers, a one year practice bar is appropriate to protect the public from future negligent conduct and encourage more rigorous compliance with professional standards.

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the revised record index issued by the Commission's Office of the Secretary on December 7, 2010, as corrected on December 21 and 27, 2010.

VI. ORDER

IT IS ORDERED, pursuant to Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e), that Wendy McNeeley, CPA, be temporarily denied the privilege of appearing or practicing before the Commission as an accountant for one year; and

IT IS FURTHER ORDERED that this administrative proceeding IS DISMISSED as to Gerard A.M. Oprins, CPA.

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

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Robert G. Mahony
Administrative Law Judge