

INITIAL DECISION RELEASE NO. 251
ADMINISTRATIVE PROCEEDING
FILE NO. 3-11194

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

In the Matter of :
: PHILIP L. PASCALE, CPA : INITIAL DECISION
: : May 17, 2004
: :

APPEARANCES: Thomas M. Melton and Karen L. Martinez for the Division of Enforcement and the Office of the Chief Accountant, United States Securities and Exchange Commission

Robert F. Van der Waag for Respondent Philip L. Pascale

BEFORE: Lillian A. McEwen, Administrative Law Judge

SUMMARY

This Initial Decision concludes that Respondent Philip L. Pascale (Pascale) did not willfully violate Section 17(a) of the Securities Act of 1933 (Securities Act), Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), or Rule 10b-5 thereunder. It further concludes that Pascale did not willfully aid and abet or cause violations of Section 15(d) of the Exchange Act and Rules 15d-1 and 15d-13 thereunder. Because Pascale did not willfully commit or aid and abet the above violations, he is therefore not subject to discipline under Rule 102(e)(1)(iii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(iii). Finally, this Initial Decision concludes that Pascale did not engage in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(ii). This Initial Decision dismisses all charges against Pascale.

I. PROCEDURAL HISTORY

The Securities and Exchange Commission (Commission) instituted these proceedings on July 29, 2003, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e). I held a three-day public hearing in New York, New York, from February 2-4, 2004, at which the Division of Enforcement and the Office of the Chief Accountant (collectively, Division) called five

witnesses, including Pascale, and Pascale called one witness. Seven exhibits from Pascale and fifty-five exhibits from the Division were admitted into evidence. The Division and Pascale filed their Post-Hearing Briefs on March 19 and March 23, 2004, respectively. The Division and Pascale filed their Reply Briefs on April 2 and April 6, 2004, respectively.¹

II. PRELIMINARY MATTERS

The document marked as “Div. Ex. 36” was discussed, used, and offered without objection at the hearing. (Tr. 108-18.) Due to an unrelated interruption, however, “Div. Ex. 36” was not formally admitted. I conclude that “Div. Ex. 36” is relevant to this proceeding and therefore should have been formally admitted into the record at the hearing. See City of Anaheim, 71 SEC Docket 191, 193-94 & nn. 4-8 (Nov. 16, 1999). Accordingly, I ORDER that the document marked as “Div. Ex. 36” is hereby admitted as part of the record.

III. ISSUES PRESENTED

The Order Instituting Proceedings (OIP) alleges that false and misleading financial statements included in filings with the Commission by Composite Holdings, Inc. (Composite),² resulted from failed audits conducted by Pascale that deviated from Generally Accepted Auditing Standards (GAAS).³ The OIP alleges that these financial statements, covering annual and quarterly reports for the periods from June 30, 1999, through December 31, 2001, were materially false because the amount recorded for a patent acquired in a merger between Composite and an entity under common control with Composite was stepped-up and recorded at an amount materially in excess of fair value, contrary to Generally Accepted Accounting Principles (GAAP).⁴ The OIP also alleges that, even if the value of the patent was recorded

¹ Citations to the transcript of the hearing will be noted as “(Tr. __.)” Citations to the Division’s and Pascale’s exhibits will be noted as “(Div. Ex. __.)” and “(Resp. Ex. __.)” respectively. Citations to the Division’s and Pascale’s Pre-Hearing Briefs will be noted as “(Div. Pre-Hearing Brief __.)” and “(Resp. Pre-Hearing Brief __.)” respectively. Citations to the Division’s and Pascale’s Post-Hearing Briefs will be noted as “(Div. Post-Hearing Brief __.)” and “(Resp. Post-Hearing Brief __.)” respectively. Citations to the Division’s and Pascale’s Reply Briefs will be noted as “(Div. Reply Brief __.)” and “(Resp. Reply Brief __.)” respectively.

² Although the OIP refers to the company as “Composite Holdings, Inc.,” every filing introduced into evidence, including Commission filings, and all testimony elicited at the hearing refers to the company either as “Composite Industries of America” or one of that company’s predecessors. This designation in the OIP appears to be a mere clerical error and will be disregarded. All references to “Composite” will hereinafter refer to “Composite Industries of America,” as it is clear that the parties believe that this is the company relevant to this proceeding.

³ “Generally Accepted Auditing Standards” are the standards prescribed for the conduct of auditors in the performance of an examination of management’s financial statements. See SEC v. Arthur Young & Co., 590 F.2d 785, 788 n.2 (9th Cir. 1979).

⁴ “Generally Accepted Accounting Principles” are the basic postulates and broad principles of accounting pertaining to business enterprises. These principles establish guidelines for

properly under GAAP, Composite's recording of a deferred tax asset related to the patent resulted in a material overstatement of assets and equity and material misstatements of net losses.

The OIP further alleges that the false financial statements were incorporated by reference into multiple registration statements filed on Form S-8. The OIP alleges that during the relevant times, Pascale provided yearly audit and quarterly review services to Composite and that he issued unqualified audit reports on its financial statements, which were included in filings with the Commission.

As a result of his conduct described above, the OIP alleges that Pascale: (1) willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; (2) willfully aided and abetted and caused violations of Section 15(d) of the Exchange Act and Rules 15d-1 and 15d-13 thereunder; and (3) engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) and (iii) of the Commission's Rules of Practice.

If I conclude that the allegations in the OIP are true, I must then determine: (1) whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Pascale should be ordered to cease and desist from committing or causing a violation and any future violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and from causing a violation and any future violation of Section 15(d) of the Exchange Act and Rules 15d-1 and 15d-13 thereunder; and (2) whether, pursuant to Rule 102(e)(1)(ii) and (iii) of the Commission's Rules of Practice, Pascale should be censured or denied, temporarily or permanently, the privilege of appearing and practicing before the Commission as an accountant.

The Division alleges that Pascale improperly: (1) changed the accounting treatment for the merger between Affordable Homes of America, Inc. (Affordable), and Composite because Merle Ferguson (Ferguson) controlled both entities at the time of their merger; (2) determined the fair value of Affordable's shares; (3) assigned a value to the patent; (4) failed to reduce the value at which the patent was carried by an impairment loss; (5) recorded a deferred tax asset; and (6) recorded Ferguson's ownership interest in Composite at fair value. (Div. Post-Hearing Brief at 5-19.)

IV. FINDINGS OF FACT

The findings and conclusions herein are based on the entire record and on the demeanor of the witnesses who testified at the hearing. I applied preponderance of the evidence as the standard of proof for the Division's case. Steadman v. SEC, 450 U.S. 91, 102 (1981). I have considered and rejected all arguments and proposed findings and conclusions that are inconsistent with this Initial Decision.

measuring, recording, and classifying the transactions of a business entity. See Arthur Young & Co., 590 F.2d at 789 n.4.

A. Background

Respondent Pascale

Pascale, a resident of Massapequa, New York, has been licensed in New York as a certified public accountant (CPA) since 1980. (Tr. 43-44.) He went into private practice in 1990, and in 1999 formed the firm Pascale, Razzino, Alexanderson & Co., where he has been a partner since its inception. (Tr. 44-45.) The last public company audit that Pascale performed was for Composite, although he still does audit work for several non-profit entities, pension plans, and private companies. (Tr. 45-46.) Pascale maintains that he did not deviate from professional accounting or auditing standards. (Tr. 85.)

Composite

On June 12, 1997, Ferguson founded Composite as a Nevada corporation. (Div. Ex. 52 at 3, 18.) Shortly thereafter, Composite acquired the patent rights for the construction material Z-mix from its inventor, Joseph Zawada (Zawada). (Tr. 65; Div. Exs. 1 at 21; 27 at 1; 32 at 2; 52 at 40.) Z-mix, a cement-like building material, might be used to build better quality homes at lower cost than homes built with actual cement, dry wall, or lumber. (Div. Exs. 1 at 3; 2 at 3-4.) At Composite's October 1997 organizational meeting, Zawada became Composite's chairman of the board of directors (the board) and was issued 6,370,000 shares of common stock. (Div. Ex. 52 at 16.) Six million of these shares were to be issued through Zawada to other persons, while Zawada retained the remaining 370,000 shares, valued at \$370,000, as consideration for the Z-mix patent. (Div. Exs. 1 at 21; 27 at 1; 52 at 22-23, 40.) All 6,370,000 shares were to have a restrictive legend that vested the shares' voting rights with the board for a period of five years. (Tr. 65; Div. Exs. 52 at 23; 55 at 8.) Ferguson, named treasurer and a member of the board, was issued 2 million shares. (Div. Ex. 52 at 16-27.) Jeff Johnson (Johnson) and Donald Stoecklein (Stoecklein), named as the other two board members, were appointed as company president and secretary, respectively. (Div. Ex. 52 at 16.) Composite initially issued 10 million shares in total. (Div. Ex. 52 at 16.)

In November 1997, Ferguson replaced Zawada as chairman of the board, following Zawada's death. (Div. Ex. 52 at 1.) In December 1997, Ferguson replaced Johnson as Composite's president and Ferguson was to receive an additional 1,250,000 shares. (Div. Ex. 52 at 3-4.) In February 1997, Ferguson founded Affordable as a Nevada corporation. (Tr. 85; Div. Ex. 1 at 7, 21-22.) On March 17, 1999, Kowtow, Inc. (Kowtow), a public shell corporation, received in a merger all the outstanding common stock of Affordable. (Div. Exs. 1 at 2; 55 at 5.) In exchange, Kowtow issued 4 million shares of its common stock to SCS Enterprises, Inc. Trust (SCS), the sole shareholder of Affordable and an alter ego of Ferguson. (Div. Exs. 1 at 2, 10; 55 at 8.) The 4 million shares that Kowtow issued to SCS represented roughly eighty percent of its issued and outstanding shares. (Div. Ex. 1 at 22.)

On that same date, Ferguson was elected company president, chief executive officer, and chairman of the board. (Div. Exs. 1 at 2; 55 at 5.) Two days later, Kowtow changed its name to Affordable. (Div. Ex. 1 at 2.) On March 31, 1999, Affordable underwent a two-for-one forward stock split, resulting in Ferguson owning 8 million shares of Affordable. (Div. Ex. 1 at 2, 10.)

About four weeks later, Affordable acquired Composite pursuant to a merger agreement. (Tr. 58-59; Div. Exs. 1 at 3; 2 at 3; 50 at 88-105.) Affordable changed its name to World Homes, Inc. (World Homes) in October 2000, and to Composite in August 2001. (Div. Ex. 3 at 3.)

Composite, a Nevada corporation, has its principal business office in Las Vegas, Nevada. (Div. Ex. 3 at 2.) During all relevant times, the common stock of Composite and its predecessors has traded on the National Association of Securities Dealers' Over-The-Counter Bulletin Board, and Composite was required to file periodic reports with the Commission pursuant to Section 15(d) of the Exchange Act. (Div. Exs. 1-3.) Composite and its predecessors have been development stage companies throughout their existence, engaged in the business of constructing residential houses in the United States and other countries. (Div. Exs. 1-3.)

Pascale's Relationship with Affordable and Composite

Pascale audited Affordable from its inception until December 31, 1998, and for its fiscal years ending June 30, 1999, and 2000. (Tr. 47-50; Div. Ex. 28.) He audited Composite from its inception until June 30, 1998, and for its fiscal year ending on June 30, 2001,⁵ serving as the engagement partner on each audit. (Tr. 47-50; Div. Ex. 28; Resp. Ex. 2 at 1.) In addition to rendering audit services, Pascale reviewed Affordable's and Composite's quarterly reports filed with the Commission. (Tr. 57-58, 185.) After the 2001 audit, Pascale ceased performing audit work for Composite because Composite owed Pascale's firm a significant fee. (Tr. 56.) Receiving payment from Composite and Affordable was typically difficult, and both entities were usually behind on paying their bills. (Tr. 56.) Ferguson paid Pascale in stock after Pascale had resigned from the account. (Tr. 57-58.)

B. The 1999 Audit and Financial Statements

Affordable accomplished its acquisition of Composite by exchanging approximately 6,514,000 shares of its common stock for the approximately 13,028,000 shares of Composite common stock that were issued and outstanding. (Tr. 64-65, 345; Div. Exs. 50 at 87, 93, 95; 55 at 5; Resp. Ex. 2 at 2.) Affordable was the surviving entity and all the stock it issued pursuant to the transaction was restricted. (Div. Exs. 2 at 4; 34 at 3; 50 at 89.) As a result of the acquisition, Affordable owned the patent rights to Z-mix. (Div. Exs. 1 at 4, 2 at 4.)

In 1999, Pascale accounted for the acquisition at historical cost, in a manner similar to a pooling of interests,⁶ because he concluded that Affordable and Composite were under common control at the time of the acquisition. (Tr. 58-59, 70, 86, 128, 149-50; Resp. Ex. 2 at 2.)

⁵ Although the company was known as Affordable and World Homes during fiscal year 2001, Composite is the name that appears on the Form 10-KSB for this period. (Div. Ex. 3.) Accordingly, when referring to the 2001 audit and financial statements, I will refer to Composite as the relevant entity.

⁶ The "pooling of interests" method of accounting requires the recorded assets and liabilities of each entity to be carried forward to the combined company at their recorded amounts. Business Combinations, Accounting Principles Board Opinion No. 16, para. 12 (1970) (APB 16).

Pascale's assessment of common control was based on his discussions with management that convinced him that the same persons owned and operated both companies. (Tr. 70, 86, 128.)

As a result, in Affordable's 1999 Form 10-K, Pascale recorded the value of the patent at \$394,313, representing the \$370,000 that Composite spent acquiring the patent, plus other costs incurred in perfecting the patent. (Tr. 60-61; Div. Exs. 1 at 12-13, 21, 30; 27 at 1.) Affordable's management believed that the patent's value should have been reported as much more than its historical cost and represented that they had engaged an independent appraiser to confirm this belief. (Tr. 59; Div. Ex. 27 at 1.) No such appraisal was obtained. (Tr. 59-60, 75, 94.)

Affordable recorded total assets at \$10,306,279, its shareholders' equity at \$4,166,435, and its amortization expense for the patent at \$39,431. (Div. Ex. 1 at 12-14.) Affordable reported a net loss of more than \$200,000 and did not report a deferred tax asset.⁷ (Div. Ex. 1 at 12-14.) Affordable's quarterly reports filed with the Commission for the periods ending September 30 and December 31, 1999, and March 31, 2000, reflected this accounting treatment. (Div. Exs. 4-6.)

Following his audit of Affordable's financial statements for the year ending June 30, 1999, Pascale issued an unqualified audit report. (Div. Ex. 1.) On December 21, 1999, Affordable filed with the Commission its 1999 Form 10-K, enclosing Pascale's unqualified audit report and its audited financial statements. (Div. Ex. 1.) During the course of the 1999 audit, Pascale resigned as a result of the non-payment of fees. (Tr. 184.)

C. The 2000 Audit and 1999 and 2000 Financial Statements

Summary

During the 2000 audit, Michael Schulman (Schulman), Affordable's chief financial officer since June 2000, requested that Pascale reconsider the manner in which he had accounted for the acquisition. (Tr. 97.) Specifically, Affordable sought to change the accounting for the acquisition to a purchase, which would step-up the patent's recorded value to fair value. The "purchase method" of accounting requires the cost of an acquired company or acquired assets to be measured by the fair value of the consideration given or the fair value of the property acquired, whichever is more clearly evident. APB 16, para. 67, 72.

Schulman convinced Pascale that Composite was not under Ferguson's control, thereby necessitating a restatement of the 1999 financial statements to account for the acquisition as a purchase. (Tr. 97, 234-41.) In particular, Schulman informed Pascale that Ferguson owned only

⁷ A "deferred tax asset" is defined as the deferred tax consequences attributable to deductible temporary differences and carryforwards. Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109, App. E, para. 289 (Financial Accounting Standards Bd. 1992) (FAS 109). A "deductible temporary difference" is defined as temporary differences that result in deductible amounts in future years when the related asset is recovered. Id. A "carryforward" is defined as deductions or credits that cannot be utilized on a tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. Id.

2 million of Composite's approximately 13 million outstanding shares at the time of the acquisition. (Tr. 234-41; Div. Ex. 38 at 1.) A letter from Stoecklein reiterated this information. (Tr. 234-41.)

Based on this information, Pascale agreed that Composite and Affordable were not under the common control of Ferguson at the time of the acquisition. (Tr. 234-41.) Pascale further agreed that the cost of acquiring Composite should be based on the fair value of the shares that Affordable issued in connection with the acquisition, a portion of which would be assigned to the patent. (Tr. 67-69, 351-52; Div. Exs. 2 at 20; 55 at 5, 10.) Thus, Affordable's financial statements for 1999 were restated as part of Pascale's 2000 audit. (Div. Exs. 2; 55 at 5.)

Pascale recognized that stepping-up the patent to fair value was the critical audit area because it would involve restating the 1999 financial statements; therefore, it required a more intense evaluation than other audit areas. (Tr. 120-22; Div. Ex. 37 at 2.) He discussed the consequences of changing the accounting method with a colleague before agreeing to the restatement and completed a pooling of interests checklist to aid in determining the appropriate accounting treatment. (Div. Ex. 38.) The colleague was Robert Cheskes (Cheskes), a licensed CPA since 1968, who served as the third-party reviewer of the 2000 and 2001 financial statements. (Tr. 243-44, 251; Div. Exs. 53-54.) In 2000, Cheskes reviewed Affordable's financial statements. (Tr. 244, 250; Div. Ex. 53 at 2.) In 2001, Cheskes reviewed the financial statements and some of Pascale's audit work papers. (Tr. 251, 261; Div. Ex. 54 at 1.) Cheskes questioned how the information could not have been disclosed in 1999, and Pascale informed him that a mistake had been made. (Tr. 248-49; Div. Ex. 53 at 5.)

Using the purchase method, Pascale determined that the fair value of Affordable's shares was nearly \$18 million, of which \$17,198,099 was assigned as the cost to acquire the patent, after costs were assigned to the other assets acquired. (Tr. 351-52; Div. Exs. 36 at 1; 55 at 5, 10, 12.) Pascale conceded that the patent was valued incorrectly in the 1999 financial statements. (Tr. 100.) In its Form 10-KSB for 2000, Affordable restated the patent's value in 1999 to \$17,024,349, less amortization of \$173,750, and recorded the patent's value for 2000 at \$15,981,849, less amortization of \$1,216,250. (Div. Ex. 2 at 8.) Affordable's restated total assets for 1999 were \$27,472,384, and its total assets for 2000 were \$19,387,523. (Div. Ex. 2 at 8.) The patent thus represented approximately sixty-two percent of Affordable's total assets in 1999, as restated, and represented approximately eighty-two percent of Affordable's total assets in 2000. (Div. Ex. 2.)

Affordable reported net losses of \$1,190,329 for 1999, as restated, and \$3,105,360 for 2000. (Div. Ex. 2.) Affordable recorded deferred tax assets of \$496,638 and \$2,262,655 for 1999, as restated, and 2000, respectively. (Div. Exs. 2 at 8; 44.) Shareholders' equity for 1999 was restated to \$15,318,821 and was recorded at \$13,222,826 for 2000. (Div. Ex. 2 at 9.) Affordable's quarterly reports filed with the Commission for the periods ending September 30 and December 31, 2000, and March 31, 2001, reflected this change in accounting treatment. (Div. Exs. 7-9.)

The notes to Affordable's financial statements explained that the restatement was necessary to correct an error in connection with the acquisition. (Div. Ex. 2 at 28.) The error

was attributed to crucial information about the legal form of the transaction that was not presented until the current year. (Div. Exs. 2 at 21.) Following his audit of Affordable's financial statements, Pascale issued an unqualified audit report. (Div. Ex. 2.) On October 10, 2000, Affordable filed with the Commission its Form 10-KSB for 2000 enclosing, with his consent, Pascale's unqualified audit report and its audited financial statements. (Div. Ex. 2.)

Evidence of Common Control

When Ferguson founded Composite in 1997, he received 2 million of the 10 million shares that Composite initially issued and was appointed its director and treasurer. (Div. Ex. 52 at 16-27.) Zawada was issued 6,370,000 shares, subject to the aforementioned restrictive legend. (Tr. 65; Div. Ex. 52 at 16-27.) Ferguson later became Composite's chairman of the board and president, and was to be issued an additional 1,250,000 shares. (Div. Exs. 52 at 1-4.) Ferguson owned at least seventy-eight percent of Affordable's shares at the time it acquired Composite. (Tr. 64, 76, 349-50, 461; Div. Exs. 1 at 2, 10, 22; 38 at 1.) He was also Affordable's founder, chief executive officer, president and chairman of the board. (Tr. 66-67; Div. Exs. 1 at 2; 34 at 3-4; 35 at 5; 50 at 105.)

Composite's total outstanding shares were approximately 13,028,000 at the time of the acquisition. (Tr. 64-65, 345; Div. Exs. 38 at 1; 50 at 95.) Ferguson owned 2 million shares, or approximately sixteen percent, but no more than twenty percent. (Tr. 65-66, 69, 98, 125, 129, 235-38, 349, 448; Div. Exs. 38 at 1; 55 at 8.) The Zawada estate owned approximately forty-seven percent of Composite's shares, and the voting rights to those shares vested with Composite's board, with Ferguson serving as chairman. (Tr. 65, 349-50; Div. Exs. 52 at 16-27; 55 at 8.) The board received only the right to vote the Zawada estate's shares, and it had no other indicia of ownership of the shares, such as the right to receive dividends or the right to sell the shares. (Tr. 444.)

There was no agreement among Composite's board as to how they would vote the Zawada estate's shares after his death, and there is no evidence of an agreement to vote in concert, but the board always voted unanimously. (Tr. 377-83, 442.) Ferguson did not control the other members of Composite's board. (Tr. 442-45.)

Pascale's work papers include a Form 8-K that Affordable filed with the Commission on April 14, 1999, which incorporated Affordable's audited financial statements for the year ending December 31, 1998. (Tr. 95-96; Div. Ex. 35.) Notes to the financial statements refer to Affordable and Composite, entities under common control, as having entered into transactions with each other. (Tr. 96; Div. Exs. 35 at 13; 55 at 7.) Similarly, notes to Composite's audited financial statements for the year ending June 30, 1998, refer to Affordable and Composite, entities under common control, as having entered into transactions with each other. (Tr. 233; Div. Exs. 52 at 39, 42; 55 at 7.) Pascale based his conclusion as to common control during each of these audits on discussions that he had with representatives of the companies and his belief that the companies were working as one. (Tr. 234-35.) Ferguson controlled Affordable because he owned seventy-eight percent of its shares at the time of the acquisition, but Ferguson did not control Composite because he did not own a majority of its shares at the time of the acquisition. (Tr. 432-51, 461; Resp. Exs. 3-4.)

The Fair Value of Affordable's Securities and Cost Assigned to Z-mix Patent

In determining the fair value of Affordable's shares, which determined the acquisition cost of Composite, Pascale and his partners first examined the average price at which the stock traded on two dates, April 26, 1999, and May 3, 1999. (Tr. 61-64; Div. Exs. 36 at 1-2; 55 at 10-12.) Affordable's shares traded at \$3.75 per share on April 26, 1999, and at \$3.438 per share a week later on May 3, an average of \$3.59 per share. (Div. Exs. 36 at 2; 55 at 10-12.) The auditors obtained these prices based on a list of Affordable's historical stock quotes provided to them by Schulman. (Tr. 61-62, 211-14; Div. Ex. 51 at 2-7.)

Between April 26 and May 3, 1999, only 200 shares of Affordable were traded at a closing price of \$2.125 per share. (Tr. 112, 571-75; Div. Ex. 36 at 2.) Pascale's partner, Tom Alexanderson, deemed this price to be an anomaly and disregarded it in averaging the quoted prices. (Tr. 112; Div. Ex. 36 at 2.)

Affordable's stock had been trading for less than three weeks at an average daily volume of approximately 12,500 shares at the time of the acquisition. (Div. Ex. 51.) Affordable, a development stage company with operating losses since its inception, issued more than 6 million additional shares to acquire Composite at a time when it had only 10 million shares issued and outstanding. (Div. Exs. 1; 2; 36; 38; 45; 55 at 10.)

Pascale and his partners discounted the \$3.59 per share average by twelve percent because the shares were restricted and another twelve percent because the stock was thinly traded. (Tr. 62-64, 108, 352-53; Div. Exs. 36 at 1-2; 55 at 10-12.) They concluded that the twenty-four percent discount was reasonable, and persons with whom they consulted concurred. (Tr. 63-64, 102-03, 105, 108, 117, 270-274.) Pascale now concedes that the discount he applied was not consistent with GAAP. (Tr. 102, 108-09.)

After applying the discount, Pascale computed the fair value of Affordable's stock to be \$2.73 per share. (Tr. 114; Div. Exs. 36 at 1-2; 55 at 10-12.) Pascale and his partners then multiplied the \$2.73 per share figure by the approximately 6,514,000 shares that Affordable issued to arrive at a fair value of the shares of nearly \$18 million. (Tr. 473-74; Div. Ex. 36 at 1.) After costs were assigned to the other assets acquired, \$17,198,099 was assigned as the cost to acquire the patent. (Tr. 351-52; Div. Exs. 2; 36 at 1.) The patent represented more than sixty percent of Affordable's total assets in 1999 and more than eighty percent of its total assets in 2000. (Div. Ex. 2.)

Although patented, Z-mix has never been approved for use in the United States or in foreign countries. (Tr. 163-66, 281, 302-03.) The company has never had a facility in which it could manufacture Z-mix, and Z-mix has never been used commercially or sold to a third party. (Tr. 167-68, 283, 305, 587; Div. Ex. 55 at 14.) No independent appraisal by an expert in stock valuation was used to determine the fair value of Affordable's shares. (Tr. 61-62, 84; Div. Ex. 55 at 12.) Similarly, an expert appraisal of the Z-mix patent was not obtained to determine its fair value, even though management represented that it would obtain one. (Tr. 59-61, 75, 84, 94; Div. Ex. 27 at 1.) Pascale correctly allocated nearly the entire value of Affordable's shares as the

cost of the patent, because acquiring the patent was the purpose of the merger. (Tr. 474-75, 480, 602.)

Pascale's method for determining the fair value of Affordable's shares was appropriate because GAAP specifies the use of quoted stock prices two or three days before and after the acquisition is agreed to and announced to determine fair value. (Tr. 463-64, 570; Resp. Ex. 2 at 7.) Pascale might have deviated from GAAP when he computed the amount of the discount in the absence of supporting evidence. (Tr. 468, 523-24, 576, 583-84.) Pascale was not required to obtain an expert appraisal to determine the fair value of Affordable's shares, because an appraisal would have been useful only if it had been performed contemporaneously with the acquisition. (Tr. 471-73, 535.)

Pascale did not consider Ferguson's sixteen percent ownership interest in Composite when stepping-up the acquisition to fair value. (Tr. 100-02, 452-455; Resp. Ex. 2 at 8.) Pascale's failure to consider Ferguson's sixteen percent ownership interest in Composite may have resulted in the value of the patent being understated by eight percent on the audited financial statements. (Tr. 103, 469-73, 523-28; Resp. Ex. 2 at 8.) The eight percent understatement resulted from the twenty-four percent discount in the shares' value, combined with the step-up of Ferguson's sixteen percent interest in Composite to fair value. (Tr. 100-04, 469-73, 523-28; Resp. Ex. 2 at 8.) This eight percent understatement was immaterial. (Tr. 523-28.)

Impairment in Value of the Z-mix Patent and Recording of a Deferred Tax Asset

Affordable did not take an impairment loss against the carrying amount⁸ of the patent in its financial statements. (Div. Ex. 2.) It also reported a deferred tax asset in its financial statements. (Div. Exs. 2; 44.) Notes to the financial statements stated that no valuation allowance⁹ was needed because management determined that there was a strong likelihood of realization of the deferred tax asset. (Div. Exs. 2; 55 at 18.)

During the 2000 audit, Pascale requested and obtained projections from Schulman for the period from July 1, 2000, until June 30, 2001. (Tr. 115, 130-34, 139; Div. Ex. 39.) Those projections showed that Affordable had entered into two joint venture agreements, one with Tristar USA, Inc. (Tristar), and the other with AL NASR Trading & Industrial Corporation, LLC (AL NASR). (Tr. 299-306; Div. Ex. 39 at 1.) Tristar is in the business of building and developing homes. (Tr. 297-302.) Pursuant to its agreement with Tristar, which was for five years, Affordable projected gross sales of \$250 million and a gross profit of \$6,250,000 for the upcoming year. (Div. Exs. 39 at 1; 50 at 38-39.) Rodney Whitney (Whitney), the president of Tristar, had provided the figures in the projections and had approved the press release

⁸ The "carrying amount" of an asset is its original cost less accumulated depreciation. Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of, Statement of Financial Accounting Standards No. 121, para. 2 (Financial Accounting Standards Bd. 1995) (FAS 121).

⁹ A "valuation allowance" is defined as the portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized. FAS 109, App. E, para. 289.

announcing the agreement. (Tr. 297-302; Div. Ex. 50 at 48.) Pursuant to its agreement with AL NASR, which was for three years with a twenty-five year optional extension, Affordable projected gross sales of \$300 million and a gross profit of \$7,500,000 for the upcoming year. (Div. Exs. 39 at 1; 50 at 36-37.) Each project, involving the construction of low-cost housing units, was to take place in a foreign country. (Div. Exs. 37 at 2; 50.) Schulman's projections were based on his conversations with the joint venture partners. (Tr. 139, 152.) Pascale questioned Schulman about the projections and then reasonably relied on the projections as support for the carrying value of the patent and deferred tax asset. (Tr. 139-41, 200, 206-09.)

Although Pascale did not contact representatives of Tristar or AL NASR during his year 2000 audit, he saw documents that referred to the agreements. (Tr. 137-39; Div. Ex. 40 at 1.) Whitney informed representatives at Affordable that Tristar did not have any executed contracts in place for the home-building projects. (Tr. 308-09, 312.) Tristar never agreed to purchase Z-mix from the company and never obtained any contracts to build homes. (Tr. 284.)

Pascale's audit addressed Affordable's ability to operate as a going concern. (Tr. 176-77, 188; Div. Ex. 45.) His work papers documented uncertainty about whether the company would secure a bank loan needed to commence construction. (Div. Ex. 45.) Although Affordable projected significant revenues from its joint venture agreements, management also represented to Pascale that it was negotiating a private placement of the company's shares. (Div. Ex. 48 at 1.) If the private placement failed, Ferguson promised to supply sufficient funds to sustain Affordable for twelve months. (Div. Ex. 48 at 1.) Pascale accepted Ferguson's assertion as true and did not evaluate whether Ferguson was capable of fulfilling it. (Tr. 190.)

As of the 2000 audit, the company remained in its development stage, had generated no revenue or sales, had no contracts in place, and had incurred cumulative net losses since inception. (Tr. 134, 142, 144, 155, 158; Div. Exs. 1-2; 37 at 2; 45; 47; 50 at 2-4.) The company also anticipated significant losses for the period from July 1, 2000, until June 30, 2001. (Div. Ex. 37 at 2.) The joint venturers had not entered into any home-building contracts. (Tr. 139, 155, 158.)

As of the 2000 audit, Z-mix had yet to be approved for use in the United States or internationally. (Tr. 163-66, 281, 302.) The company did not have a facility or the raw materials needed to manufacture Z-mix. (Tr. 167-68, 305, 587.) Z-mix had not been used commercially as of the 2000 audit and Affordable had not sold Z-mix to a third party. (Tr. 283; Div. Ex. 55 at 14.) No appraisal of the Z-mix patent was obtained as of the 2000 audit. (Tr. 59-60, 75-76, 84, 94; Div. Exs. 27 at 1; 55 at 13-18.)

In his assessment of whether the patent was impaired, Pascale conducted his examination in accordance with GAAS by relying on the projected cash flows. (Tr. 497-505; Resp. Ex. 2.) Ferguson's representations provided additional support for Pascale's determination and Pascale was not required to obtain evidence corroborating such representations. (Tr. 503-05, 560-66.) Pascale acted reasonably in concluding that no impairment was necessary, in spite of the lack of revenue. (Tr. 497-05; Resp. Ex. 2.)

It would have been unreasonable to take an impairment loss on the patent in the same year in which its value was restated and Pascale should have obtained an appraisal of the patent

only if he had determined it was impaired. (Tr. 500-05, 536.) Pascale acted consistently with applicable auditing standards in determining that the deferred tax asset would be realized in the future by relying on the projections management provided. (Tr. 487-88.)

D. The 2001 Audit and Financial Statements

Summary

In its 2001 Form 10-KSB, Composite recorded the value of the Z-mix patent at \$14,939,349, less amortization of \$2,258,750. (Div. Ex. 3 at 8.) Composite's total assets were \$18,227,287. (Div. Ex. 3 at 8.) Thus, the patent represented approximately eighty-two percent of Composite's total assets. Composite reported a net loss of \$2,740,898, and recorded a deferred tax asset of approximately \$2,390,000. (Div. Exs. 3; 44.) Shareholders' equity was recorded at \$11,827,781. (Div. Ex. 3.) The financial statements included in Composite's quarterly reports filed with the Commission for the periods ending September 30 and December 31, 2001, continued to reflect the change in accounting treatment. (Div. Exs. 10-11.)

Following his audit of Composite's financial statements for the year ending June 30, 2001, Pascale issued an unqualified audit report. (Div. Ex. 3.) On October 12, 2001, Composite filed with the Commission its Form 10-KSB enclosing, with his consent, Pascale's unqualified audit report and audited financial statements. (Div. Ex. 3.)

Impairment in Value of the Z-mix Patent and Recording of a Deferred Tax Asset

The company did not take an impairment loss against the carrying amount of the patent in its 2001 financial statements. (Div. Ex. 3.) It also reported a deferred tax asset in its 2001 financial statements. (Div. Exs. 3; 44.) Notes to the financial statements stated that no valuation allowance was needed because management determined that there was a strong likelihood of realization of the deferred tax asset. (Div. Exs. 3; 55 at 18.)

During Pascale's 2001 audit, Bill Morris (Morris), Composite's chief financial officer, projected revenues of \$122 million and total gross profits of \$15,250,000 from its joint venture agreements. (Tr. 148; Div. Exs. 40 at 1; 50 at 12.) Morris's projections were based on his conversations with the other parties to the agreements, who remained seriously interested in the projects, and information supplied to Schulman by Ferguson. (Div. Exs. 40 at 1; 50 at 12.) The projections were also based on the assumption that the projects would be completed within the year. (Div. Ex. 40 at 2.)

After receiving this information, Pascale requested additional evidence to support the projections because the previous year's had not been achieved. (Tr. 154; Div. Ex. 41 at 1.) In response, Morris provided Pascale with contacts at Tristar and AL NASR along with copies of the joint venture agreements. (Tr. 154-56; Div. Ex. 43 at 1.) Morris also identified governmental and financing contingencies that existed before they could obtain executed contracts. (Tr. 163; Div. Ex. 43 at 1.)

Pascale spoke with Whitney and with John Switzer (Switzer) of AL NASR. (Tr. 142, 150-51, 315-16, 323; Div. Ex. 40 at 2-3.) Both men expressed optimism regarding Z-mix and a

desire to go forward with the projects. (Tr. 155, 503; Div. Ex. 40 at 2-3.) Whitney was concerned about Composite's lack of a central facility to manufacture Z-mix but was assured that Z-mix could be made on-site instead. (Div. Ex. 40 at 2.) Switzer informed Pascale that AL NASR was not in the business of building homes; rather, its business consisted of providing packaging and credit enhancements for financial products issued by creditors. (Tr. 151; Div. Ex. 40 at 3.) AL NASR was going to assist Composite by providing it with financing to commence its construction projects. (Tr. 151; Div. Ex. 40 at 3.) Switzer believed that Composite was a prime candidate to obtain financing and would receive it soon. (Div. Ex. 40 at 3.)

Based on his conversations with Whitney and Switzer, Pascale projected gross sales of \$92 million from the Tristar project and gross sales of \$1.2 billion from the AL NASR project. (Tr. 156-61; Div. Ex. 42.) These projections were based on the Tristar project selling 4,000 housing units at an average price of \$23,000 per unit, and the AL NASR project selling 100,000 housing units at an average price of \$12,000 per unit. (Div. Ex. 42.) Pascale prepared his own projections because he was not satisfied with the projections Morris provided him. (Tr. 157.)

Pascale relied on management's projections and his conversations with representatives of Tristar and AL NASR as support for the carrying amount of the patent and deferred tax asset. (Tr. 206-09; Div. Exs. 40 at 3; 50 at 14.) Cheskes concurred with the valuation of the patent in 2001, but did not consider whether its value was impaired, nor did he review any joint venture agreements or cost analysis of Z-mix in reviewing Pascale's audit work papers. (Tr. 263-66, 269-70.)

Pascale's 2001 audit addressed Composite's ability to operate as a going concern. (Div. Exs. 47.) Cheskes also questioned whether Composite would continue as a going concern. (Tr. 261-63; Div. Ex. 54.) Ferguson again promised to contribute sufficient funds to Composite to sustain operations for twelve months in the event that the company did not obtain sufficient working capital from its joint venture agreements. (Tr. 177, 504, 560; Div. Exs. 46 at 1; 47 at 1.) Pascale accepted Ferguson's assertions about his ability to provide sufficient funding to Composite, although there is no evidence in Pascale's work papers that established Ferguson's ability to provide such funding. (Tr. 181-82, 540-41, 560.) Pascale did not verify this representation because he concluded that Composite's expenses could be insignificant if it reduced operations. (Tr. 181.)

As of the 2001 audit, Composite remained in its development stage, had generated no revenue or sales, had no contracts in place, and had incurred cumulative net losses since its inception. (Tr. 134, 142, 144, 155, 158; Div. Exs. 1-3; 47; 50 at 2-4.) Its failure to generate revenue caused it to experience liquidity shortfalls. (Div. Ex. 47.) Composite also anticipated significant losses for the period from July 1, 2001, until June 30, 2002. (Div. Exs. 37 at 2; 50 at 3.) Neither joint venture commenced operations during the year ending June 30, 2001, due to a lack of financing, although the agreements remained in place. (Div. Ex. 40 at 1.) Management expected to commence construction in its joint venture projects during the upcoming fiscal year, but no construction had taken place as of September 2001. (Tr. 147-48; Div. Ex. 40 at 1.) The joint venturers had not entered into home-building contracts. (Tr. 139, 155, 158.)

As of the 2001 audit, Z-mix had yet to be approved for use in the United States or internationally. (Tr. 163-66, 281, 302.) Composite did not have a facility or the raw materials

needed to manufacture Z-mix. (Tr. 167-68, 305, 587.) Whitney made a down payment on a factory, but Ferguson did not follow through with the purchase. (Tr. 310-12, 318-19.) Whitney attempted to help Composite secure a test of Z-mix, but Ferguson never obtained the necessary funds to conduct such test. (Tr. 328-30.) Z-mix still had not been used commercially as of the 2001 audit, and Composite had not sold Z-mix to a third party. (Tr. 283; Div. Ex. 55 at 14.) No appraisal of the Z-mix patent was obtained as of the 2001 audit. (Tr. 59-60, 75-76, 84, 94; Div. Exs. 27 at 1; 55 at 13-18.)

In his assessment of whether the patent was impaired, Pascale conducted the examination in accordance with GAAS by relying on the projected cash flows and communicating with the joint venturers. (Tr. 497-505; Resp. Ex. 2.) Ferguson's representations provided additional support for Pascale's determination and Pascale was not required to obtain evidence corroborating such representations. (Tr. 503-05, 560-66.) Pascale acted reasonably in concluding that no impairment was necessary, in spite of the lack of revenue, and Pascale should have obtained an appraisal of the patent only if he had determined it was impaired. (Tr. 497-505, 536; Resp. Ex. 2.) He acted consistently with applicable auditing standards in determining that the deferred tax asset would be realized in the future by relying on the projections management provided. (Tr. 487-88.)

Registration Statements

Affordable's and Composite's annual reports filed on Form 10-KSB for its fiscal years ending June 30, 1999, 2000, and 2001, included the audited financial statements and Pascale's unqualified audit reports. These were incorporated by reference into fourteen registration statements filed with the Commission on Form S-8 between November 13, 2000, and April 18, 2002. (Div. Exs. 13-26.) Several quarterly reports filed with the Commission on Form 10-QSB were also incorporated by reference into these registration statements. (Div. Exs. 13-26.)

Subsequent Events

During Composite's third quarter of its 2002 fiscal year, Pascale addressed Composite's ability to operate as a going concern due to its lack of revenue. (Tr. 182.) Pascale requested that Ferguson provide information about his personal financial position to support Ferguson's assertion that he would provide Composite with sufficient funds to sustain operations. (Tr. 182-83, 191.) Ferguson never provided this information and Pascale issued a going concern report for this quarter. (Tr. 190-91.) Shortly thereafter, Pascale resigned from the account. (Tr. 192.) In its quarterly report for this period, Composite wrote off the entire value of the patent and the entire value of the deferred tax asset. (Tr. 589; Div. Ex. 12 at 4.) Pascale concurred with the write off. (Tr. 589; Resp. Ex. 2 at 3.)

V. CONCLUSIONS OF LAW

The OIP alleges that Pascale willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. The OIP also alleges that Pascale willfully aided and abetted and caused violations of Section 15(d) of the Exchange Act and Rules 15d-1 and 15d-13 thereunder. It charges that because Pascale willfully committed or aided and abetted the above violations, he is therefore subject to discipline under Rule

102(e)(1)(iii). Finally, the OIP alleges that Pascale engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) during his audits.

A. Legal Standards

Antifraud Provisions

Section 17(a) of the Securities Act prohibits fraudulent conduct in the offer and sale of securities, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraudulent conduct in connection with the purchase and sale of securities. These provisions prohibit essentially the same type of conduct. See United States v. Naftalin, 441 U.S. 768, 773 n.4 (1979).

To establish violations of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, the Division must show: (1) misrepresentations or omissions of material facts or other fraudulent devices; (2) made in connection with the offer, sale, or purchase of securities; and (3) that the respondent acted with scienter. Scienter is not necessary to prove violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act; rather, a respondent's negligence may establish liability. Aaron v. SEC, 446 U.S. 680, 697 (1980); SEC v. Solucorp Indus., 274 F. Supp. 2d 379, 419 (S.D.N.Y. 2003); SEC v. Scott, 565 F. Supp. 1513, 1525-26 (S.D.N.Y. 1983).

Auditors violate Exchange Act Section 10(b) and Rule 10b-5 when they prepare and certify publicly filed financial statements that they know, or are reckless in not knowing, are false. Ponce v. SEC, 345 F.3d 722, 729-30, (9th Cir. 2003); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225-27 (10th Cir. 1996); Russell G. Davy, 48 S.E.C. 138, 142-43 (1985), aff'd, 792 F.2d 1418 (9th Cir. 1986). Auditors also violate these provisions by issuing a false audit report. McGann v. Ernst & Young, 102 F.3d 390, 397 (9th Cir. 1996).

A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision and would view disclosure of the omitted fact as having significantly altered the total mix of information made available. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Accounting and auditing literature do not define materiality by strictly quantitative measures. Staff Accounting Bulletin No. 99, 70 SEC Docket 1043, 1044 (Aug. 19, 1999). "Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment." Id. at 1045 (citation omitted).

Proving willful conduct requires a showing of intent to commit the act that constitutes a violation, not intent to violate. Wonsover v. SEC, 205 F.3d 408, 413-15 (D.C. Cir. 2000); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976).

Aiding and Abetting or Causing Violations of Periodic Reporting Provisions

Section 15(d) of the Exchange Act and Rule 15d-1 thereunder require issuers that have filed registration statements for securities under the Securities Act with the Commission to file annual reports that include, among other things, certain financial information. Pursuant to these requirements, the issuer is required to file financial statements that: (1) were prepared in accordance with GAAP; and (2) contained a report prepared by an independent auditor certifying that the auditor had audited the company's financial statements in conformity with GAAS to determine whether the statements were prepared in conformity with GAAP. Cf. Russell Ponce, 73 SEC Docket 442, 451 (Aug. 31, 2000) (citing Regulation S-X, 17 C.F.R. § 210.4, et seq.), aff'd, 345 F.3d 722 (9th Cir. 2003). Exchange Act Rule 15d-13 further obligates the issuer to file quarterly reports, which must also contain financial information.

The obligation to file annual and quarterly reports includes the obligation that the filings be true and correct, containing no material misstatements or omissions. SEC v. IMC Int'l Inc., 384 F. Supp. 889, 893 (N.D. Tex. 1974), aff'd, 505 F.2d 733 (5th Cir. 1974). Financial statements filed with the Commission that are not prepared in conformity with GAAP are presumed to be misleading or inaccurate. 17 C.F.R. § 210.4-01(a)(1).

To find that a respondent aided and abetted, the record must demonstrate: (1) the existence of an independent primary violation; (2) the respondent provided substantial assistance in the commission of the primary violation; and (3) the respondent's general awareness or reckless disregard of the primary violation and of his role in furthering the violation. Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000); SEC v. Fehn, 97 F.3d 1276, 1288 (9th Cir. 1996); The Rockies Fund, Inc., 81 SEC Docket 703, 729 (Oct. 2, 2003); Terence Michael Coxon, 80 SEC Docket 3288, 3300 (Aug. 21, 2003).

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to order any person who was a cause of a violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation. To issue such an order, the Division must establish that: (1) a primary violation occurred; (2) there was an act or omission by the respondent that was a cause of the violation; and (3) the respondent knew, or should have known, that his conduct would contribute to the violation. Robert M. Fuller, 80 SEC Docket 3539, 3545 (Aug. 25, 2003) (citing Erik W. Chan, 77 SEC Docket 851, 859-60 (Apr. 4, 2002)), appeal pending, No. 03-1334 (D.C. Cir.). The "should have known" language is akin to negligence. KPMG Peat Marwick LLP, 74 SEC Docket 384, 421 (Jan. 19, 2001). Finding that a respondent willfully aided and abetted a violation necessarily makes him a cause of such violation. Coxon, 80 SEC Docket at 3300 n.32 (citing Richard D. Chema, 53 S.E.C. 1049, 1059 n.20 (1998); Dominick & Dominick, Inc., 50 S.E.C. 571, 578 n.11 (1991)).

Rule 102(e)(1)(ii) and (iii)

Rule 102(e)(1)(iii) permits the Commission to sanction accountants who have willfully violated, or willfully aided and abetted the violation of any provision of the federal securities

laws or the rules and regulations thereunder. The alleged violations are of the antifraud and periodic reporting provisions.

Rule 102(e)(1)(ii) permits the Commission to sanction accountants who have engaged in improper professional conduct. “Improper professional conduct” is defined as: (1) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; (2) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which [the respondent] knows, or should know, that heightened scrutiny is warranted; or (3) repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission. 17 C.F.R. § 201.102(e)(1)(iv).

In addition to the alleged deviations from GAAP, the OIP charged that Pascale failed to comply with GAAS during the audits because he failed to: (1) exercise due professional care; (2) maintain an attitude of professional skepticism; (3) obtain and evaluate sufficient competent evidential matter upon which to base an opinion; and (4) render an accurate audit report.

An auditor has a duty to exercise due professional care in the performance of the audit and the preparation of the audit report. Codification of Accounting Standards and Procedures, Statements on Auditing Standards, §§ 150.02, 230.01 (American Inst. of Certified Pub. Accountants 1999). Due professional care, in turn, requires the auditor to exercise professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of the audit evidence. Id. § 230.07.

The auditor is required to obtain sufficient competent evidential matter through inspection, observation, inquiries, and confirmations to afford a reasonable basis for his opinion regarding the financial statements. Id. §§ 150.02, 326.01. Representations from management are part of the evidential matter the auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements. Id. § 333.02. When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for purposes of an independent audit than that which is secured solely within the entity. Id. § 326.21. An auditor’s education and experience provides him with knowledge about business matters in general, but the auditor is not expected to have the expertise of a person qualified to engage in another profession or occupation. Id. § 336.06. When the auditor encounters matters requiring special skill or knowledge, such as valuation, the auditor may, in his judgment, decide that use of a specialist is required in order for the auditor to obtain competent evidential matter. Id. §§ 336.06, .07.

The auditor is responsible for evaluating the reasonableness of management’s estimates, which he should consider with an attitude of professional skepticism. Id. § 342.04. In evaluating the reasonableness of an estimate, the auditor should focus on key factors and assumptions that are: (1) significant to the accounting estimate; (2) sensitive to variations; (3) deviations from historical patterns; and (4) subjective and susceptible to misstatement and bias. Id. § 342.09. The auditor should also obtain an understanding of how management developed the estimate. Id. § 342.10.

An audit report is required to state whether the financial statements are presented in accordance with GAAP. Id. § 150.02. An auditor is permitted to express an unqualified opinion that a company's financial statements are presented in accordance with GAAP only when the auditor's opinion is formed on the basis of an audit performed in accordance with GAAS. Id. § 508.07. When financial statements contain a material departure from GAAP or there is a lack of sufficient competent evidential matter, the auditor should express a qualified or adverse opinion or should disclaim an opinion. Id. § 508.35, et seq. Consequently, issuing an unqualified audit report for financial statements containing a material departure from GAAP or where there is a lack of sufficient competent evidential matter constitutes a failure to comply with GAAS.

B. GAAP and GAAS

The Division alleges that Pascale violated the antifraud provisions by issuing materially false audit reports on Affordable's and Composite's financial statements. Specifically, the Division claims that Pascale's audit reports falsely claimed that the financial statements presented fairly, in all material respects, the company's financial position in conformity with GAAP. (Div. Post-Hearing Brief at 27; Div. Reply Brief at 1-2.) The Division further claims that Pascale falsely represented that his audits were conducted in accordance with GAAS and formed a reasonable basis for his opinion. (Div. Post-Hearing Brief at 27-28.) Because the alleged GAAS and GAAP deviations relate only to specific areas of the financial statements, they will be discussed in that context.

I begin my evaluation of Pascale's conduct with a discussion of the inherent limitations on auditing:

No audit provides complete assurance that the financial statements are free from material error arising from either incorrect processing of accounting data or incorrect judgments on the selection and application of accounting principles. As the Commission on Auditors' Responsibilities noted:

Audited financial statements cannot be perfectly accurate, in part because of the ambiguity of the accounting concepts they reflect. . . [In addition,] . . . the financial statements [] cannot be more accurate and reliable than the underlying accounting measurement methods permit. For example, no one, including accountants, can foresee the results of many uncertain future events. To the extent that the accuracy of an accounting presentation is dependent on an unpredictable future event, the accounting presentation will be inaccurate. The audited accounting presentation can be no more accurate, for the auditor cannot add certainty where it does not exist.

Moreover, accounting measurement principles frequently provide more than one alternative to account for a given transaction or event. For example, there are several ways of accounting for the flow of inventory costs through an

enterprise and for the depreciation of tangible assets. Neither the authoritative accounting literature nor logic supports the selection of one alternative over another. This flexibility of [GAAP] permits preparers of financial information to influence the information presented and thereby affect the reliability and accuracy of that information. Also, as noted on several occasions in this chapter, accounting principles often require interpretation and the application of judgment before they can be applied to specific transactions and other events and circumstances, and reasonable preparers of financial statements and auditors can disagree about those interpretations and judgments. In effect, the “established criteria” of [GAAP] against which financial statement assertions are evaluated are sometimes less than completely “established.”

Jerry D. Sullivan, et al., Montgomery’s Auditing 19 (10th ed. 1985) (footnotes omitted).

Affordable’s Acquisition of Composite

Under APB 16, all business combinations were to be accounted for according to either the purchase method or pooling of interests method. APB 16, para. 8. Use of the pooling method was required whenever all twelve criteria set forth in APB 16 were satisfied; otherwise, the purchase method was to be used. APB 16, para. 8, 45-48, 50.

APB 16, however, does not apply to a “transfer of net assets or exchange of shares between companies under common control.” APB 16, para. 5. In such circumstances, the assets and liabilities of the acquired company are to be accounted for at historical cost in a manner similar to pooling of interests. Transfers and Exchanges Between Companies Under Common Control, Accounting Interpretations of APB 16, #39 (AICPA 1973) (AIN-APB16, #39).

In 1999, Pascale reasonably concluded that Composite and Affordable were under the control of Ferguson. Consequently, he accounted for the acquisition at historical cost. In 2000, however, Pascale agreed to restate Affordable’s 1999 financial statements to account for the transaction as a purchase, because he correctly concluded that Ferguson did not control Composite at the time of the acquisition.

The Division argues that Pascale improperly changed the accounting treatment for the transaction because Ferguson controlled both Affordable and Composite at the time of the acquisition. (Tr. 346-52; Div. Ex. 55 at 5-10; Div. Post-Hearing Brief at 5-10.) The Division, relying on Related Party Disclosures, FAS No. 57 (FASB 1982) (FAS 57), and Rule 1-02 of Regulation S-X, argues that control means “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.” (Div. Ex. 55 at 7; Div. Post-Hearing Brief at 6.) In contrast, Pascale argues that, based on Definition of “Common Control” in Relation to FASB Statement No. 141, Emerging Issues Task Force No. 02-5, (EITF 02-5),¹⁰ and a speech given by a member of the

¹⁰ Business Combinations, Statement of Financial Accounting Standards No. 141 (Financial Accounting Standards Bd. 2001), superseded APB 16 for all business combinations initiated after June 30, 2001.

Commission's Office of the Chief Accountant in 1997 (Common Control Speech), common control is established only when an individual owns more than fifty percent of the outstanding voting interest in each entity. (Tr. 238, 432-51; Resp. Exs. 3-4; Resp. Reply Brief at 9-13.)

The sources on which the Division relies are not persuasive. Regulation S-X sets forth the required content and format of disclosures in financial statements, including the requirement that the financial statements be prepared in conformity with GAAP. 17 C.F.R. §§ 210.1-01, 4-01. The rules, however, defer to FASB and APB, among others, in developing and maintaining the GAAP to be used in actually preparing the financial statements. James D. Cox, et al., Securities Regulation: Cases and Materials, 51 n.1 (2d ed. 1997); Darin Bartholomew, Is Silence Golden When It Comes To Auditing?, 36 J. Marshall L. Rev. 57, 63 (2002). Put another way, Regulation S-X primarily addresses what information needs to be presented in financial statements whereas FASB and APB address the methods by which such information is obtained. The instant proceeding deals with the evaluation of allegedly deficient accounting methods, not insufficient financial statement disclosure. As such, it would be counterintuitive to allow FASB and APB to delineate the appropriate accounting standards only to apply definitions of terms contained in rules governing disclosure. Moreover, even if GAAP did not contain the applicable definition, there is no indication that Regulation S-X was intended to fill the gaps left by the accounting authorities. Similarly, there is no indication that Regulation S-X was intended to apply to accounting for business combinations or exchanges of shares between companies under common control. Accordingly, I conclude that the definition of common control in Regulation S-X is inapplicable to the instant matter.

I also conclude that FAS 57 is inapplicable. FAS 57 provides guidance on financial statement disclosure relating to, among other things, enterprises under common ownership or management control. FAS 57, para. 1, 4. FAS 57 reflects a concern that certain control relationships between entities may result in significantly different financial results from that which would be attained if the entities were autonomous. FAS 57, para. 4; App. A, para. 14. Therefore, in order to guarantee that no material is omitted that may be necessary to ensure that the financial information presented validly represents the underlying events, FAS 57 requires disclosure of control relationships, with control defined broadly. FAS 57, para. 4; App. A, para. 14-16. Like Regulation S-X, FAS 57 is concerned primarily with what information is presented in the financial statements, not with the underlying events (i.e., the accounting methods) applied in obtaining such information. Because this proceeding involves allegedly improper accounting methods, not improper financial statement disclosure, a definition contained in a disclosure-related pronouncement should not apply. Furthermore, there is no indication that the terms defined in FAS 57 were intended to apply to other accounting pronouncements, including accounting for business combinations and exchanges of shares between entities under common control. Accordingly, it will not be applied here. In addition, I credit and adopt the opinion of Pascale's expert, Jeffrey Brinn (Brinn), that the mere right to vote shares does not equal control. (Tr. 432-51.)

In EITF 02-5, the Task Force recognized that the Commission's staff has indicated that common control exists only in certain situations, the most pertinent of which here is where an individual has a common majority ownership of the outstanding voting interests in each entity. EITF 02-5, para. 3. However, the Task Force did not reach a consensus on how common control

between entities is to be determined. EITF 02-5, para. 5. Due to the failure to reach a consensus, the Commission observer of the project stated that registrants should continue to follow the guidance set forth in paragraph 3, which mirrors the guidance set forth in the Common Control Speech. EITF 02-5, para. 7. Based on their similar content, the Task Force's reference to the staff's stated position as to common control, the fact that the Common Control Speech was given in 1997, and Brinn's opinion, I conclude that paragraph 3 was based on the Common Control Speech. (Tr. 509-10.)

Because FASB did not reach a consensus in EITF 02-5 and it was published well after the events at issue here, it is of limited value. In addition, speeches given by members of the Commission's staff are not in the hierarchy of authorities upon which accountants and auditors rely, nor are a staff member's views to be imputed to the Commission, as evidenced by the standard disclaimer preceding the Common Control Speech. (Resp. Ex. 4 at 1.) Nevertheless, it would defy logic for an accountant or auditor to ignore a public statement from a Commission staff member, especially when the Commission has the authority to discipline such professionals. Thus, although the Common Control Speech is not binding, it may be persuasive authority. Furthermore, the Commission observer's advice that registrants "continue to follow the guidance in paragraph 3" suggests that the standards in paragraph 3 have been the applicable standards since at least 1997, the year the Common Control Speech was given.

Additional support for the applicability of these standards is contained in APB 16. Specifically, paragraph 5 of APB 16 excludes exchanges of shares between companies under common control from the application of APB 16 and refers to paragraph 2 of Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51), for a description of control. According to paragraph 2 of ARB 51, a controlling financial interest in an entity is defined as ownership of more than fifty percent of the outstanding voting shares. Although EITF 02-5 specifically states that common control is not defined in APB 16, the reference to ARB 51 cannot be overlooked. The APB surely would not have referred to ARB 51 as describing control in this context had it intended a different description to apply. Based on the foregoing, I conclude that common control may be established only by common majority stock ownership.

Because Ferguson owned more than a majority of Affordable's shares, he controlled Affordable. With respect to Composite, however, Ferguson owned only approximately sixteen percent of the outstanding shares. The restrictive legend on the Zawada estate's shares only granted Composite's board the right to vote such shares, not any other rights typically associated with stock ownership, such as the right to dispose of the shares or the right to receive dividends. Moreover, the Division has not pointed to any rule, regulation, or pronouncement on GAAP that equates the right to vote shares with ownership of such shares. Because Ferguson did not own more than a majority of Composite's outstanding shares, he did not control Composite. Consequently, Affordable's acquisition of Composite was not an exchange of shares between entities under common control.

Even if I were to accept the Division's broad definition of control, I would reach the same conclusion. Based on the Division's definition, Ferguson controlled Composite as a result of his stock ownership, his control over the voting rights of the Zawada estate's shares, and his positions within Composite's corporate hierarchy. (Tr. 346-52, 375; Div. Ex. 55 at 5-10; Div.

Post-Hearing Brief at 5-10.) Ferguson owned only sixteen percent of Composite's shares, with the remainder owned by other shareholders. All the shares of Composite were subsequently transferred to Affordable pursuant to the merger. AIN-APB16, #39 states that paragraph 5 of APB 16 only excludes exchanges of shares that do not involve "outsiders."¹¹ When all of the existing outsider interests do not remain outstanding after the exchange, the transaction does not qualify as an exchange of shares between companies under common control. See AIN-APB16, #39. As set forth above, Affordable acquired all the outstanding shares of Composite, including the shares held by Ferguson, the purported controlling person, as well as those held by the other shareholders. Because these other shareholders' (or outsiders') interests did not remain outstanding after the acquisition, the transaction cannot be construed as an exchange of shares between companies under common control. see generally Issues Relating to Accounting for Business Combinations, FASB Technical Bulletin No. 85-5, para. 6, 12 (FTB 85-5) (finding that purchase method generally applies when non-controlling shareholders are party to exchange of shares.)

Based on the foregoing, I conclude that Affordable's financial statements were properly restated to account for the transaction according to the purchase method. I further conclude that Pascale's audit was conducted in accordance with GAAS and provided a reasonable basis for his opinion that the financial statements, as restated, presented fairly, in all material respects, the company's financial position in accordance with GAAP.

A principal contention of the Division's is that Pascale ignored references to the companies being under common control contained in notes to the financial statements that he audited in 1998. (Div. Ex. 55 at 7; Div. Post-Hearing Brief at 7-8.) This contention is misguided. These notes state that the companies had entered into transactions with one another. In such circumstances, FAS 57 requires disclosure of control relationships, with "control" defined broadly, in order to ensure that no material information is omitted. Thus, while the companies might have been under common control for disclosure purposes, it does not follow that they were also under common control for purposes of accounting for exchanges of shares between companies under common control.

In any event, I conclude that Pascale exhibited an appropriate degree of skepticism, care, and diligence throughout the course of his audits. He understood that control is demonstrated only by common majority stock ownership, even if he did not rely on the Common Control Speech. (Tr. 69, 238.) Therefore, Ferguson's positions within Composite's corporate structure were not relevant, including his positions as president, chief executive officer, and chairman of the board. (Tr. 78-94; Div. Exs. 28-34.) When Pascale was confronted with management's representations as to Ferguson's ownership interest in Composite, he recognized that re-evaluating the transaction was the most critical audit area and required more attention. He contacted Cheskes, his third-party reviewer, to discuss the consequences of a restatement and completed a pooling of interests checklist to assist in determining the appropriate accounting treatment. Upon considering management's representations, Pascale concluded that the evidence

¹¹ Due to the context involved in AIN-APB16, #39, I infer that the term "outsider" means a shareholder with a non-controlling interest.

presented to him was sufficiently credible and persuasive to warrant signing off on the restatement.

Fair Value of Affordable's Shares

Because Affordable and Composite were not under the common control of Ferguson, the transaction was required to be accounted for as a purchase. As previously stated, this method requires the cost of the acquired company to be measured by the fair value of the consideration given or the fair value of the acquired company, whichever is more clearly evident. APB 16, para. 67, 72. Typically, the fair value of securities traded in the market is more clearly evident than the fair value of the acquired company. Id., para. 74. As a result, the quoted market price of a security issued in a business combination may usually be used to approximate the fair value of the acquired company after recognizing the possible effects of price fluctuations, quantities traded, the issuance of a large number of shares, or other uncertainties that may influence the quoted price. Id., para. 23, 74. The presence of such factors may render the fair value of the stock not objectively determinable. Id., para. 23.

The market price for a reasonable period before and after the date the terms of the acquisition are agreed upon and announced should be considered in determining fair value. Id., para. 74. The "reasonable period of time" referred to in paragraph 74 of APB 16 is very short, such as a few days before and after the acquisition is agreed to and announced. Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination, EITF No. 99-12, para. 4.

If the quoted market price is not the fair value of the stock, the consideration received should be estimated even though it may be difficult. APB 16, para. 75. The consideration received and the extent of the adjustment of the quoted market price of the stock issued should be weighed to determine the amount to be recorded. Id., para. 75. Independent appraisals may be used as an aid in determining the fair value of securities issued. Id., para. 75. Fair value must be determinable within reasonable limits. Barry C. Scuttillo, 80 SEC Docket 2646, 2652 (July 28, 2003).

The Division contends that under the circumstances of this case, APB 16 required Pascale to obtain an independent appraisal of Affordable's shares in order to determine their fair value. (Div. Post-Hearing Brief at 11-14.) Because he failed to obtain such an appraisal, the Division contends that Pascale deviated from GAAP and GAAS. (Div. Post-Hearing Brief at 14.)

Pascale and his partners first took the quoted price of Affordable's shares from two dates. They averaged these prices and then took a twenty-four percent discount because the shares were restricted and thinly traded. After applying the discount, the fair value of Affordable's stock was set at \$2.73 per share, which was then multiplied by the approximately 6,514,000 shares that Affordable issued to arrive at a total acquisition cost of nearly \$18 million.

Pascale did not consider stock price quotations between the two dates because his partner believed that these quotations were an anomaly. Pascale and his partners believed that the

discount was reasonable, and persons with whom they consulted concurred. No appraisal of Affordable's shares was ever obtained.

There is no evidence that Pascale considered that Affordable was a development stage company, had incurred losses since its inception, or issued more than 6 million additional shares to acquire Composite when it had 10 million shares outstanding. Prior to the acquisition, Affordable's shares had been trading for approximately three weeks at an average daily volume of approximately 12,500 shares. Because Pascale and his partners apparently calculated the fair value of Affordable's shares and then audited their own calculation, they were testing the reasonableness of their own determination rather than the reasonableness of management's determination. (Tr. 576-82.) Management did, however, concur after the fact. (Tr. 577.)

Pascale and Brinn both conceded that the twenty-four percent discount was not appropriate under the circumstances. Brinn also opined that use of an independent appraiser may be appropriate to determine the fair value of a stock when the quoted stock price is not used. (Tr. 569-70.) He further conceded that Pascale's auditing of his own calculation was not entirely consistent with GAAS. (Tr. 518, 576-82.) Brinn opined that an independent appraisal was not required here because one would have been useful only when done contemporaneously with the acquisition. Conversely, the Division's expert, Richard Graff (Graff), opined that Pascale's failure to obtain an appraisal of the shares deviated from GAAP and GAAS. (Tr. 351-55, 384-87, 630-32; Div. Ex. 55 at 10-13.)

For the following reasons, however, I conclude that Pascale did not deviate from GAAP or GAAS in determining the fair value of Affordable's shares. In deciding on the appropriate discount, Pascale and his partners consulted with outside sources. Everyone involved agreed that the amount of the discount was reasonable. Although Pascale and both experts now second-guess this judgment, I conclude that Pascale acted reasonably under the circumstances. Paragraph 75 of APB 16 permits adjustments of the quoted market price and use of estimates in determining the amount to be recorded when the quoted price is not indicative of the stock's fair value. Even Graff acknowledged as much in his testimony. (Tr. 354, 384, 632.)

Because Pascale took a discount from the quoted stock price, he determined that the quoted stock price was not indicative of its fair value. Even when the quoted stock price is not the fair value of shares, however, APB 16 merely permits the use of independent appraisals in ascertaining the fair value of shares; it does not require them. See APB 16, para. 75. Similarly, GAAS permits the use of valuation specialists in order to obtain competent evidence about matters outside the auditor's expertise; it does not require them. See AICPA, AU §§ 336.06, .07. Taken together, these provisions allow an auditor to exercise his discretion in deciding whether he has sufficient and competent evidence of a stock's fair value. In addition, I adopt Brinn's expert opinion that an appraisal contemporaneous with the acquisition was the only useful type of appraisal under the circumstances. (Tr. 471-73, 535.)

Affordable's shares were publicly traded, thereby providing indicia of their fair value by virtue of available price quotations. Although the shares were thinly traded and restricted, which indicates that they were of limited marketability, Pascale took these factors into account in adjusting the quoted stock price. I reject Graff's expert opinion that Pascale was also required to

consider other factors. (Tr. 351-54, 384-87; Div. Ex. 55 at 10-13.) Moreover, the Division has offered no proof that an appraiser would have assigned a materially different value or that the value actually assigned was not within reasonable limits. At the time, Pascale concluded that the fair value of Affordable's shares was reasonably and objectively stated. I will not reject what amounts to an exercise of judgment in the absence of contrary evidence.

Lastly, although Pascale apparently tested his own calculation of the fair value of Affordable's shares, no deviation from GAAS can be derived from his conduct because Pascale's partners and several outside sources were in close consultation on the matter. The involvement of these additional accountants provides the same type of quality assurances that GAAS is designed to provide.

Based on the foregoing, I conclude that, as to the fair value of Affordable's shares, the financial statements certified by Pascale presented fairly, in all material respects, the company's financial position in accordance with GAAP. I further conclude that Pascale's audit was conducted in conformity with GAAS and furnished a reasonable basis for his opinion.

Assignment of Cost to the Z-mix Patent

Following his determination of the fair value of Affordable's shares, thus determining the cost of the acquired company, Pascale's next step was to assign a cost to the patent. APB 16, para. 68, 87. Paragraph 87 of APB 16 provides that, "all identifiable assets acquired, either individually or by type, . . . should be assigned a portion of the cost of the acquired company, normally equal to their fair value at date of acquisition." Paragraph 87 provides further that independent appraisals may be used as an aid in determining the fair value of the assets acquired. Paragraph 88(e) of APB 16, as a general guide for assigning fair value to assets, suggests that an appraised value be assigned to intangible assets, including a patent.

Here, the fair value of the shares that Affordable issued in the transaction was determined to be nearly \$18 million, of which \$17,198,099 was assigned as the cost to acquire the patent, after costs were assigned to the other assets acquired. The value of the patent represented more than sixty percent of Affordable's total assets in 1999, and more than eighty percent of the total assets in 2000. No independent appraisal of the patent was obtained.

The Division argues that APB 16 requires an independent appraisal to determine the fair value of the patent because Affordable lacked an operational history; second, the patent had not been used commercially or approved for use; and, finally, the patent represented most of Affordable's total assets. (Div. Ex. 55 at 13; Div. Post-Hearing Brief at 14-15; Div. Reply Brief at 2-3.) Pascale argues that even if the entire step-up in value had not been assigned to the patent, any portion not so assigned would have been allocated to the asset "goodwill," which has the same amortization period. (Tr. 475; Resp. Reply Brief at 16-17.) As a result, Pascale contends no material misstatements would have been present on the financial statements. (Tr. 475; Resp. Reply Brief at 16-17.) I do not find Pascale's argument persuasive. While the similar amortization periods may have had a similar effect on certain aspects of the financial statements, the actual assignment of value to the patent, if inflated, could have presented a materially false impression of the patent's worth.

Clearly, all the assets of an acquired company are to be assigned a portion of the total cost and the cost assigned to such assets is to be equal to their fair value. APB 16, para. 87. Contrary to the Division's assertion, however, paragraphs 87 and 88 of APB 16 do not require the use of an independent appraisal in ascertaining the fair value of the patent, regardless of the circumstances involved. The language referred to above merely states that such an appraisal may be used as an aid in determining fair value and that, as a general guide, intangible assets be assigned appraised value. Id., para. 87, 88. This cannot be construed as a mandate to use independent appraisals in assigning value to acquired assets; rather, the permissive language suggests that the auditor or accountant is allowed to exercise his judgment in assigning such value. Furthermore, as set forth above, GAAS does not require the auditor to use specialists in order to obtain competent evidence about matters outside the auditor's expertise. See AICPA, AU §§ 336.06, .07. Thus, the auditor is allowed to exercise his discretion as to whether he has sufficient competent evidence to support his opinion. I adopt Brinn's expert opinion that Pascale acted within professional standards in assigning the value to the patent. (Tr. 475, 480.) I reject Graff's expert opinion that Pascale was required to obtain an appraisal. (Tr. 356, 613-14, 635; Div. Ex. 55 at 13-18.) Accordingly, I conclude that Pascale was not required to obtain an appraisal of the patent in order to comply with GAAP and GAAS.

Finally, the Division has offered no evidence that the value assigned to the patent was materially different from the value that an independent appraiser would have assigned. Absent such proof, I cannot conclude that the value assigned to the patent deviated materially from its fair value. Based on the foregoing, I conclude that, as to the cost assigned to the patent, the financial statements certified by Pascale presented fairly, in all material respects, the company's financial position in accordance with GAAP. I further conclude that his audit was conducted in conformity with GAAS and provided a reasonable basis for his opinion.

Failure to Record an Impairment Loss Against the Patent

Paragraph 4 of FAS 121 requires an entity to review its assets, including intangibles, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of the asset should be assessed include the following:

a significant decrease in the market value of an asset; a significant change in the extent or manner in which an asset is used or a significant physical change in an asset; a significant adverse change in legal factors or the business climate that could affect the value of an asset; an adverse action or assessment by a regulator; and a current period operating or cash flow loss combined with a history of operating or cash flow losses.

Id., para. 5. If these or other events or changes in circumstances are present, the entity is required to estimate the future cash flows expected to result from the use of the asset and its eventual disposition. Id., para. 6. When the expected future cash flows are less than the carrying amount of the asset, the entity must recognize an impairment loss. Id., para. 6.

Estimates of expected future cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. Id., para. 9. All available evidence should be considered in developing such estimates, and the weight given to the evidence should be commensurate with the extent to which the evidence can be objectively verified. FAS 121, para. 9. Other than these limitations, FASB did not address how to project cash flows, nor did it include specific limits on assumptions used to estimate expected future cash flows. Id., App. A, para. 88, 90. FASB intended the measurement guidance in FAS 121 to be general. Id., App. A, para. 87.

Neither Affordable nor Composite recorded an impairment loss against the patent's carrying value in any year, based on the projected revenues from its joint venture agreements with Tristar and AL NASR. The Division contends that the company had no past revenue producing operations that would support the carrying value of the patent. (Div. Post-Hearing Brief at 15.) It further contends that the joint venture agreements provided no likelihood of future revenue or evidence of future positive cash flows needed to support the carrying value. (Div. Post-Hearing Brief at 15-18.) As a result, the Division argues that the financial statements that Pascale certified deviated materially from GAAP and his audit was not conducted in accordance with GAAS. (Div. Post-Hearing Brief at 15-18; Div. Reply Brief at 7.)

I conclude that, as to the carrying value of the patent, the financial statements certified by Pascale presented fairly, in all material respects, the company's financial position in conformity with GAAP. I further conclude that Pascale's audits were conducted in accordance with GAAS and furnished a reasonable basis for his opinion. Initially, there was an "event or change in circumstances" that required assessment of the carrying amount of the patent; namely, that Affordable had a current operating loss along with a history of losses. In fact, Affordable had generated losses since inception and expected significant losses in the future. Thus, an estimate of the future cash flows expected to result from use of the patent had to be obtained. Management provided Pascale with projections in 2000 and 2001 to support the carrying value of the patent. In 2000, management projected gross sales of \$250 million and a gross profit of \$6,250,000 from the Tristar agreement, and projected gross sales of \$300 million and a gross profit of \$7,500,000 from the AL NASR agreement. In 2001, management projected revenues of \$122 million and total gross profits of \$15,250,000.

FAS 121 does not specify how projections are to be generated or include limitations on the assumptions underlying such projections, other than they be reasonable and supportable. In 2000, Pascale requested and received projections from management that covered the carrying value of the patent. He understood that the projections were based on Schulman's conversations with the joint venture partners and that the projects were to take place outside the United States. He was aware that the company was in its development stage, had sustained losses since its inception, anticipated significant losses in the future, and that it was uncertain whether the company would secure a bank loan needed to commence construction. There was no evidence of a business plan for either venture, and there were no contracts between the joint venture partners and a third party. Z-mix had not been used commercially or approved for use in any jurisdiction.

Pascale examined evidence that established that the joint venture agreements existed, and management represented that Whitney had provided the figures in the projections and approved

the press release announcing the agreement. He questioned Schulman about the projections, was satisfied that they were reasonable, and then relied on the projections as support for the carrying amount of the patent. Although he did not investigate the agreements, the parties thereto, or document his testing of the projections, I conclude that he was not required to do so. In this regard, I adopt Brinn's expert opinion that Pascale acted reasonably and within professional standards in relying on management's projections in 2000. (Tr. 497-505.) It would have been unreasonable for an accountant to restate the financial statements and take an impairment loss in the same year. (Tr. 500-05.) An appraisal would have been useful only if Pascale had determined that the patent was impaired. (Tr. 536.)

After the failure of the projections for 2000, Pascale requested and obtained additional evidence to verify management's representations in 2001. Morris identified financing and government approval contingencies that existed before executed contracts could be obtained. Pascale understood that the projections were predicated on Morris's discussions with the joint venture partners and information supplied by Ferguson. He also understood that the projections were predicated on the assumption that the projects would be completed within the year. Pascale was also aware of the company's financial position and that the projects had yet to commence operations. The agreements remained in place and management informed Pascale that they expected to begin construction within the upcoming year.

Pascale had discussions with the joint venture partners, and then generated his own projections because he was dissatisfied with management's representations. Both joint venture partners informed Pascale that they wanted to go forward with the projects, and Switzer informed him that the company would receive financing soon. He concluded that the evidence he obtained was sufficiently reliable and competent and supported the carrying amount of the patent. I adopt Brinn's expert opinion that Pascale fulfilled his obligations under GAAS in 2001. (Tr. 497-505.)

In 2000, management informed Pascale that it would be undertaking a private placement of the company's shares. Furthermore, in both 2000 and 2001, to alleviate Pascale's concerns about the company's ability to continue operations, Ferguson assured Pascale that he would provide funds to the company in the event that the projections were not achieved. These representations provide additional support for Pascale's conclusion that the carrying amount of the patent was adequately supported, even in the absence of evidence corroborating such representations. (Tr. 503-05, 560-66.) Based on the foregoing, I conclude that Pascale fulfilled his obligations under GAAP and GAAS.

Recording of the Deferred Tax Asset

FAS 109 establishes the accounting standards for income taxes, including the recognition and measurement of a deferred tax asset. After a deferred tax asset has been recognized and measured, it must be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than fifty percent) that some portion or all of the deferred tax asset will not be realized. FAS 109, para. 17. All available evidence, positive and negative, should be considered in determining whether a valuation allowance is needed, including historical information and currently available information regarding future

years. Id., para. 20. If historical information is not available, such as with a start-up company, then special attention is required. Id.

When there is negative evidence of cumulative losses in recent years, concluding that no valuation allowance is needed is difficult. Id., para. 23. Other examples of negative evidence include, but are not limited to, a history of operating losses and the existence of unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels in future years. Id. Nevertheless, positive evidence of sufficient quality and quantity can counteract negative evidence to support the conclusion that, based on the weight of all available evidence, no valuation allowance is needed. FAS 109, App. A, para. 103. Examples of positive evidence include, but are not limited to, existing contracts or a strong earnings history. Id., para. 24. The more negative evidence that exists the more positive evidence is necessary. Id., para. 25. An entity must use judgment in considering the impact of positive and negative evidence, and the weight given to the potential effect of each should be commensurate with the extent to which it can be objectively verified. Id.

Affordable recorded deferred tax assets of \$496,638 and \$2,262,655 in 1999, as restated, and 2000, respectively. Composite recorded a deferred tax asset of nearly \$2,390,000 in 2001. Notes to the financial statements stated that no valuation allowance was needed because management determined that there was a strong likelihood of realizing the deferred tax asset.

The Division contends that no deferred tax asset should have been reported in the financial statements because the company had incurred cumulative losses since inception, no revenues, and no credible evidence to support its projections. (Div. Post-Hearing Brief at 18-19; Div. Reply Brief at 6.) Because Affordable and Composite did report deferred tax assets under such circumstances, the Division contends that the financial statements certified by Pascale deviated materially from GAAP and that Pascale deviated from GAAS.

I conclude that, insofar as the deferred tax asset is concerned, the financial statements certified by Pascale presented fairly, in all material respects, the company's financial position in accordance with GAAP. I further conclude that Pascale fulfilled his obligations under GAAS and that his audit provided a reasonable basis for his opinion. I adopt Brinn's expert opinion on this issue. (Tr. 487-88.)

Pascale was aware that the company had incurred cumulative losses since inception and expected significant losses for the upcoming years. The company had generated no sales, revenue or income, and had no contracts in place and neither joint venturer had obtained contracts. Pascale and Cheskes expressed concerns about the company's ability to operate on a going-forward basis. Z-mix had not been approved for use or used commercially. Furthermore, Pascale knew that the construction projects were subject to governmental approval and had not yet received the necessary financing. Neither joint venture had commenced operations as of the 2001 audit.

Although the company did not have any positive earnings history or any existing contracts, paragraph 24 of FAS 109 is not an exclusive list of items that constitute "positive"

evidence. Other matters, including the joint venture agreements, can also provide positive evidence supporting the conclusion that no valuation allowance was needed in 2000 and 2001.

In 2000, Pascale requested and obtained projections from management based on the joint venture agreements. Management projected gross sales of \$250 million and gross profits of \$6,250,000 from the Tristar agreement, and gross sales of \$300 million and gross profits of \$7,500,000 from the AL NASR agreement. Pascale was aware that the projections were based on Schulman's conversations with the joint venture partners. Management represented that Whitney had provided the figures set forth in the projections and had approved the press release announcing the agreement. Pascale questioned Schulman and was satisfied that the projections were reasonable. He then relied on the projections as support for recording the deferred tax asset. Management also informed Pascale that it was preparing a private placement of the company's shares to secure working capital and Ferguson promised to supply the company with funding to allow it to sustain operations.

In 2001, management projected cumulative gross revenues of \$122 million and cumulative gross profits of \$15,250,000. Management informed Pascale that it expected to commence the projects within a year and identified a variety of contingencies that existed. It also informed him of the assumptions underlying and basis for the projections. In addition, Pascale was aware that the agreements remained in place and that management expected to commence operations in the upcoming year.

Pascale requested additional evidence to support the projections, due to the fact that the 2000 projections had not been achieved. Pascale determined that Tristar and AL NASR were existing and operating entities. He also contacted representatives at each company in order to investigate the status of the projects and Whitney and Switzer both expressed their desire to go forward. Switzer also informed Pascale that he expected Composite would obtain financing soon. Pascale then tested management's projections and generated his own projection schedule because he was not satisfied with management's representations. In other words, he investigated the basis for the projections and tested these representations when they did not come to fruition for the year 2000. Furthermore, Ferguson again promised to provide the company with funding in the event that the agreements did not generate the anticipated amounts of working capital.

Pascale had ample evidence that he deemed to be sufficiently competent and reliable upon which to base his opinion. He exercised an appropriate degree of care and skepticism throughout his audits, especially when management's projections were not achieved. I cannot conclude that the law requires anything more of him.

Failure to Record Ferguson's Sixteen Percent Interest in Composite at Historical Cost

Pascale and Brinn concede that Pascale should have considered Ferguson's sixteen percent ownership interest in Composite when stepping up the transaction to fair value. Specifically, both agree that Ferguson's interest in Composite should have been accounted for at historical cost, with the remaining eighty-four percent accounted for at fair value because this portion constituted minority interests subject to purchase accounting. (Tr. 451-55, 523-28.) Pascale and Brinn also concede that Pascale's failure to consider this resulted in the value of the

patent being understated by eight percent. The eight percent understatement resulted from the allegedly improper twenty-four percent discount in the shares' value combined with the allegedly improper step-up of Ferguson's sixteen percent interest in Composite. The Division has now essentially adopted these opinions in crafting its argument. (Div. Post-Hearing Brief at 10; Div. Reply Brief at 2, 5.) Predictably, the parties take opposing views as to the materiality of this understatement.

Arguments and factual matters falling outside the scope of the OIP are considered only for limited purposes, such as background. Int'l S'holders Servs. Corp., 46 S.E.C. 378, 386 n.19 (1976) ("The range of inquiry is broad. But it is not limitless."); see also Russell W. Stein, 79 SEC Docket 3098, 3114 n.34 (Mar. 14, 2003) (rejecting argument outside scope of order instituting proceedings). The OIP alleges that Affordable properly accounted for the acquisition at historical cost in its 1999 financial statements because the entities were under common control. (OIP at 2-3.) It then alleges that Affordable improperly restated the acquisition from historical cost to fair value. (OIP at 3.) The OIP further alleges that this step-up caused the company's assets and equity to be materially overstated and had a material effect on net losses and cites specific dollar amounts and percentages. (OIP at 3.) Finally, the OIP alleges that Pascale issued unqualified audit reports when he knew or was reckless in not knowing that the accounting for the acquisition of an entity under common control was improper. (OIP at 4.) There are no allegations relating to the failure to record Ferguson's sixteen percent ownership interest in Composite at historical cost in accounting for the transaction or on its effect on other accounts.

Based on the OIP, the scope of the inquiry into the acquisition is limited to whether or not the companies were under common control. Put another way, the OIP alleges only that Pascale erred in concluding that the companies were not under common control, not that he erred in failing to properly account for an acquisition of a minority interest. As a result of Pascale's erroneous conclusion, the OIP alleges that the accounting method was changed improperly from historical cost to fair value. Thus, the OIP contemplates that only one accounting method should be applied, whereas the Division's argument here seeks to incorporate both accounting methods. The fact that the Division did not contemplate this argument in bringing this case is further evidenced by its absence from all prehearing filings and Graff's report and testimony. The Division's argument seems to rest solely on Pascale's and Brinn's testimony.

This argument is not within the scope of the OIP. On one hand, the Division's argument may arise out of the same operative facts set forth in the OIP. On the other, the argument was not raised until well after the hearing and is not alleged in the OIP. This raises issues regarding proper notice of the charges. Nevertheless, even if the Division's new-found argument is within the scope of the OIP, I conclude that it has no merit.

The Division's argument and Brinn's conclusion assumes that Affordable's acquisition of eighty-four percent of Composite's shares not owned by Ferguson constituted an acquisition of minority shareholder interests. (Tr. 451-55, 523-28.) Generally, the acquisition of some or all of the stock held by minority shareholders of a subsidiary—whether acquired by the parent, the subsidiary itself, or another affiliate—should be accounted for by the purchase method. APB 16, para. 5, 43; see also AIN-APB16, #39 (concluding that such an acquisition is never considered a

transfer or exchange of shares by companies under common control). Acquisition of Minority Interest, Accounting Interpretations of APB16, #26, identifies the following examples of acquisitions of minority interests: (a) a parent exchanges its common stock for the common stock held by minority shareholders of its subsidiary; (b) the subsidiary buys back the common stock held by its minority shareholders; and (c) another subsidiary of the parent exchanges its common stock for the common stock held by minority shareholders of the affiliated subsidiary. Based on this interpretation, the term “affiliate” as used in paragraph 43 of APB 16 includes only another subsidiary of the common parent company. see also FTB 85-5 para. 5, 6 (concluding that shares of minority shareholders of one subsidiary of parent exchanged for shares of other subsidiary of parent is an acquisition of minority interest); Exchanges of Ownership Interests Between Entities Under Common Control, EITF No. 90-5 (same).

Based on these provisions, I conclude that the Division’s argument and Brinn’s conclusion are misguided. The plain language of paragraphs 5 and 43 of APB 16 requires that the minority interest acquired be of a subsidiary. Moreover, the acquirer can be only the parent company, the subsidiary itself, or another subsidiary of the common parent. Thus, a parent - subsidiary relationship is necessary and the acquirer must be related to the acquired in a specific manner. Because neither of these elements are present here, I conclude that Affordable’s acquisition of the eighty-four percent of Composite’s shares not held by Ferguson did not constitute the acquisition of a minority interest.¹²

Additionally, the use of the terms “minority interest” and “minority shareholders” indicates ownership of fewer than a majority of shares. Here, the Division and Brinn essentially contend that eighty-four percent of Composite’s shares comprised the minority interest. I reject their interpretation because it contradicts the very definition of “minority.” See Merriam-Webster’s Collegiate Dictionary 742 (10th ed. 1998). Furthermore, paragraph 43 of APB 16 requires purchase accounting be applied when a minority interest is acquired, and also specifies that a single method of accounting should be applied to the entire transaction. FTB85-5 also appears to require application of one method of accounting for the entire transaction. See FTB85-5, para. 12 (determining that in transactions involving both an acquisition of a minority interest and an exchange of shares between companies under common control, the accounting method applied depends on whether the minority shareholders were a party to the exchange). In this case, the Division and Brinn contend that Ferguson’s interest should have been accounted for at historical cost with the remainder accounted for at fair value. In light of the above, I cannot conclude that accounting for the acquisition in segments is appropriate.

Assuming arguendo that Brinn’s conclusion is correct and an eight percent understatement in the value of the patent resulted from the improper discount and improper step-up of Ferguson’s interest, I conclude that this understatement was not material because it did not alter the total mix of information available. I adopt Brinn’s expert opinion in this regard. (Tr. 523-28.) I reject Graff’s expert opinion. (Tr. 625-27.) Therefore, I also conclude that the financial statements certified by Pascale presented fairly, in all material respects, the company’s

¹² As a result of reaching this conclusion, I will not address whether the exchange lacked substance, which would preclude application of the purchase method. See FTB 85-5, para. 6.

financial position in conformity with GAAP, and that the audit was conducted in accordance with GAAS and furnished a reasonable basis for his opinion.

C. Conclusion

Overall, Affordable's restated financial statements for the year 1999 may not have been flawless, but any discrepancies were not material and resulted from mere differences in judgment. (Tr. 607-09.) The financial statements for 2000 and 2001 contained no material misstatements. (Tr. 506-07, 607-09.) Based on the foregoing, I conclude that the financial statements certified by Pascale presented fairly, in all material respects, the company's financial position in accordance with GAAP. I further conclude that Pascale's audits were conducted in conformity with GAAS and provided a reasonable basis for his opinion. Accordingly, I conclude that Pascale did not willfully violate Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, or Rule 10b-5 thereunder.

Consequently, I conclude that Pascale did not willfully aid and abet or cause violations of Section 15(d) of the Exchange Act, or Rules 15d-1 or 15d-13 thereunder. I further conclude that Pascale is not subject to discipline pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(iii). Finally, I conclude that Pascale did not engage in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(ii).

VI. CERTIFICATION OF RECORD

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I hereby certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on April 5, 2004, and the additional exhibit I admitted into evidence in this Initial Decision.

VII. ORDER

Based on the findings and conclusions set forth above:

IT IS ORDERED that the proceeding brought against Respondent Philip L. Pascale be and it hereby is DISMISSED.

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

correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Lillian A. McEwen
Administrative Law Judge