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Client: 56630-00001

March 12, 2015

VIA HAND DELIVERY

Brent J. Fields
Secretary
Office of the Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1106

MAR 12 2015
Washington, DC
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3-16430
SEC
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Re: *In the Matter of Mark E. Laccetti, CPA*, PCAOB File No. 105-2009-007 –
Application for Commission Review of Determination by the Public Company
Accounting Oversight Board

Dear Mr. Fields:

Pursuant to Section 19(d)(2) of the Exchange Act, 15 U.S.C. § 78s(d)(2), and Rule 440 of the Securities and Exchange Commission’s (“Commission”) Rules of Practice, Mark E. Laccetti through undersigned counsel hereby applies for Commission review of the Final Decision and Order Imposing Sanctions (“Decision”) issued by the Public Company Accounting Oversight Board (“PCAOB” or “Board”) on January 26, 2015 in the above-referenced action. The Board erred in its Decision as summarized below, and accordingly the Commission should reverse the Decision and dismiss the proceedings against Mr. Laccetti with prejudice.

Please find enclosed three copies of this Application for Commission Review, as well as the Notices of Appearance required by Rule 102 of the Commission’s Rules of Practice. We have caused copies of the foregoing to be sent by electronic mail to the Secretary of the Public Company Accounting Oversight Board.

Mr. Laccetti was subjected to findings of wrongdoing and sanctions in this case on the basis of proceedings before the PCAOB that deprived Mr. Laccetti of his fundamental right to due process and the assistance of counsel, and that were conducted under an unconstitutional statutory framework. Accordingly, Mr. Laccetti is applying for Commission review of the Board’s determinations set forth on pages 73 through 82 of its Decision, dated January 26, 2015. These errors require that the Board’s Decision be reversed, and that the proceedings against Mr. Laccetti be dismissed.

Procedural History

In June 2007, the PCAOB’s Division of Enforcement and Investigations (“Division”) began investigating the audits and reviews of Taro Pharmaceutical Industries Ltd. (“Taro”). Mr. Laccetti was the engagement partner for the 2004 audit of the financial information of Taro’s US-based subsidiary, Taro Pharmaceutical U.S.A., Inc. On July 27, 2007, the Division issued an

Brent J. Fields
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Accounting Board Demand to Mr. Laccetti, requiring him to produce documents and appear for sworn testimony in December 2007. By letter dated September 20, 2007, Mr. Laccetti requested permission to have a technical expert accounting consultant attend his sworn testimony to assist his counsel at the time. *See* Index for the Record on Review, Record Document (“R.D.”)¹ 187 (Ex. 1 to Respondent Mark E. Laccetti’s Proposed Findings of Fact and Conclusions of Law). By letter dated September 26, 2007, the Division’s Director, Claudius B. Modesti, denied Mr. Laccetti’s request, stating “the presence of a technical expert consultant at the testimony sessions of present and former E&Y personnel in the above-referenced formal investigation is not appropriate at this time.” *Id.* Thereafter, the Division examined Mr. Laccetti for four days—November 29, November 30, December 6, and December 7, 2007. Throughout this testimony, Mr. Laccetti’s counsel had no technical expert consultant present to assist them.

On October 20, 2009, the Board issued an Order Instituting Disciplinary Proceedings (“OIP”) pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002 and PCAOB Rule 5200(a)(1) against Mr. Laccetti. R.D. 1. In his Answer to the OIP, Mr. Laccetti asserted as his third affirmative defense that “[t]he PCAOB did not permit a technical expert consultant to attend Mr. Laccetti’s initial testimony by the Staff, violating Mr. Laccetti’s rights to counsel and to due process of law.” *See* R.D. 10 at 11 (Answer of Mark E. Laccetti (Dec. 7, 2009)). Mr. Laccetti also asserted, as his eighth affirmative defense, that “[t]he proceedings against Mr. Laccetti are invalid because the establishment and structure of the PCAOB violates the U.S. Constitution.” *Id.* at 13.

On June 28, 2010, the Supreme Court of the United States held that the PCAOB was unconstitutional. *Free Enterprise Fund v. PCAOB*, 561 U.S. 477, 492, 496 (2010) (“*FEF*”). After a nine-day hearing in June and July 2010, the Hearing Officer issued an initial decision in this matter on April 20, 2011. Mr. Laccetti and the Division both petitioned for Board review of the Hearing Officer’s initial decision, and the Board issued its Decision nearly four years later—on January 26, 2015.

Statement of Alleged Errors

1. At pages 74 through 78 of the Board’s Decision, the Board held that the Division did not violate Mr. Laccetti’s right to counsel. Mr. Laccetti applies for Commission review of this determination because the Division violated Mr. Laccetti’s right to counsel when it refused to permit a technical expert consultant—an accountant—to assist his attorneys during Mr. Laccetti’s investigative testimony in this matter. The Board’s error warrants reversal and dismissal of these proceedings.

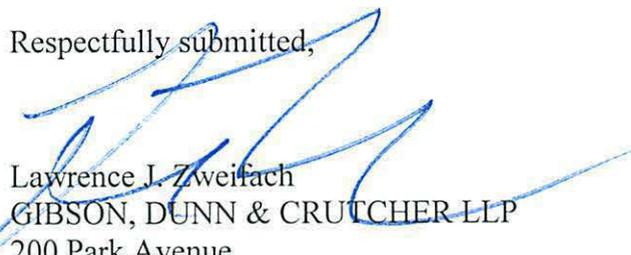
¹ Pursuant to Rule 440(d) of the Commission’s Rules of Practice, within fourteen days after receipt of this application for review, the Board must certify and file with the Commission one copy of the record in this action, along with three copies of an index of such record.

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2. At pages 78 through 82 of the Board's Decision, the Board held that the United States Supreme Court's decision in *FEF* does not require dismissal of this proceeding. Mr. Laccetti applies for Commission review of this determination because the Board's structure during the initiation, investigation and prosecution of this matter was unconstitutional. The Board's actions in relation to this matter—including but not limited to the Board authorizing the initiation of the investigation of Mr. Laccetti in 2007, the investigation that the Division conducted, the Board issuing its OIP against Mr. Laccetti in 2009, and the discretion that the Division and the Board employed—were by-products of this unconstitutional structure. The Board's conclusion to the contrary warrants reversal and dismissal of these proceedings.

Accordingly, the Commission should reverse the Board's Decision and dismiss this proceeding with prejudice.

Respectfully submitted,



Lawrence J. Zweifach
GIBSON, DUNN & CRUTCHER LLP
200 Park Avenue
New York, NY 10166-0193

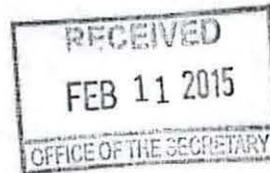
Enclosures

cc: Phoebe W. Brown (*via email, w/ enclosures*)

February 10, 2015

By Messenger

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549



Re: Final Disciplinary Sanctions Imposed on Mark E. Laccetti, CPA

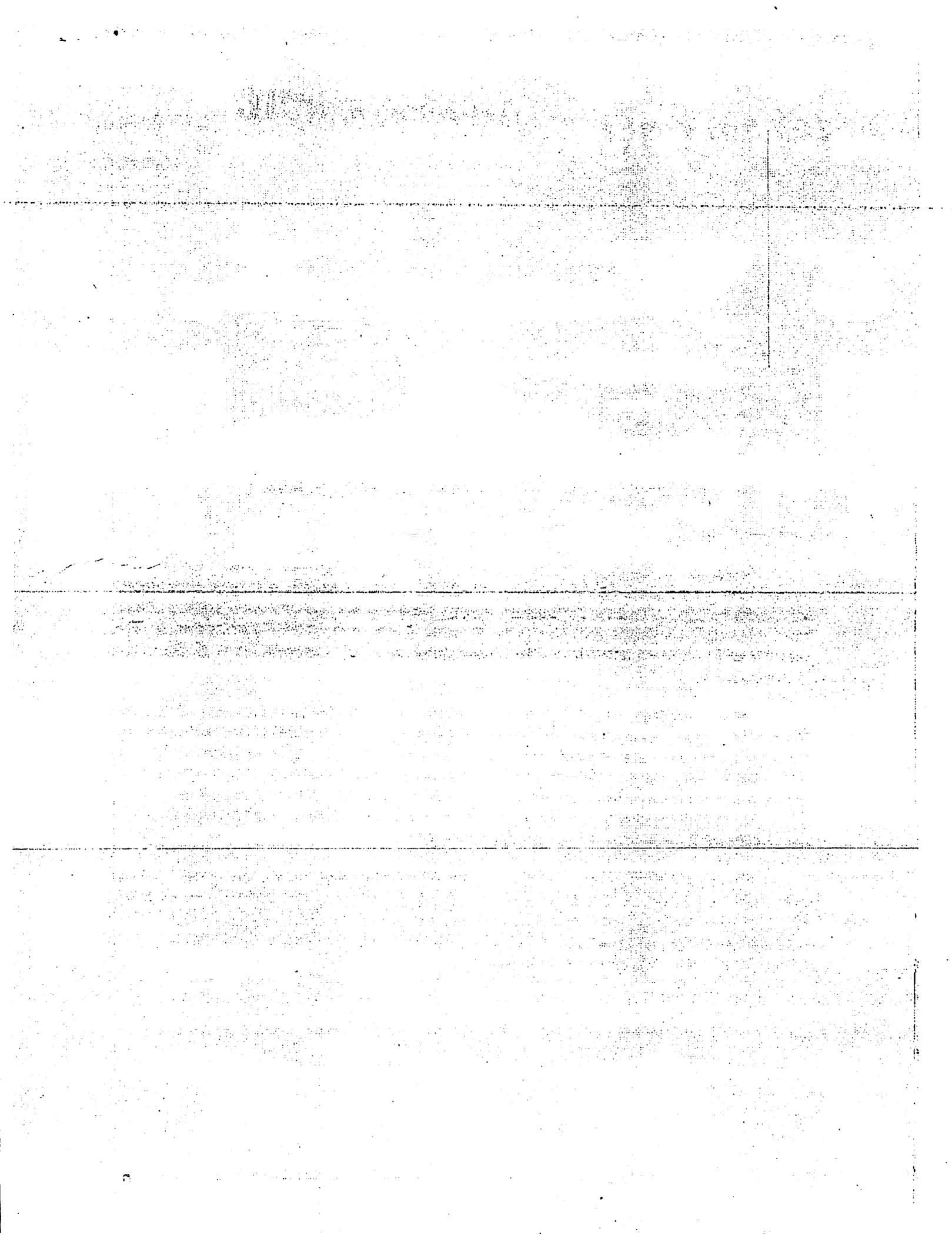
3-16430

Dear Mr. Fields:

Pursuant to Sections 105(d) and 107(c)(1) of the Sarbanes-Oxley Act of 2002 ("Act") and Commission Rule 19d-4(c), 17 C.F.R. § 240.19d-4(c), the Public Company Accounting Oversight Board ("Board") hereby notifies the Commission that the Board has imposed final disciplinary sanctions on Mark E. Laccetti, CPA ("Respondent"). The last known business address of the Respondent is 1650 Market Street, Suite 4500, Philadelphia, PA 19103-7341.

The enclosed Final Decision ("Decision") and Order Imposing Sanctions ("Order") include a description of the relevant conduct and a statement of the sanction imposed and the reasons therefor. The Order provides that the sanctions will take effect upon the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review on its own initiative, or, in the event of Commission review, upon the lifting of the stay imposed pursuant to Section 105(e) of the Act.

Please note that the Board is not making the Decision and Order public at this time. Section 105(d)(1)(C) of the Act provides that the Board shall report the sanctions to the public "once any stay on the imposition of such sanction has been lifted." Accordingly, the Board will not make the Decision and Order public until the later of the dates described in the previous paragraph.



PCAOB

Public Company Accounting Oversight Board

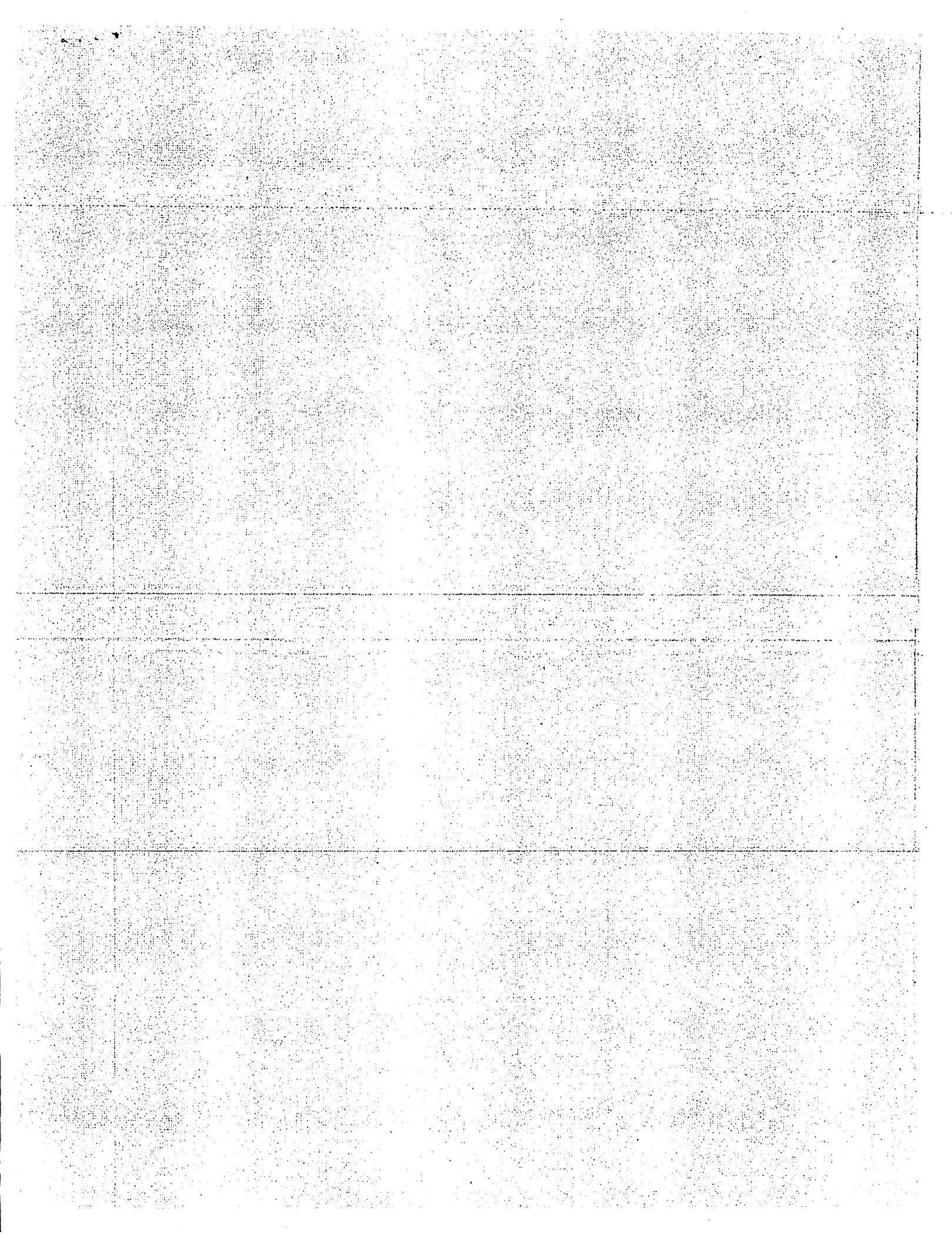
If you have any questions concerning this matter, please feel free to contact me at (202) 207-9073.

Sincerely,

A handwritten signature in black ink, appearing to read 'Phoebe W. Brown', with a long horizontal flourish extending to the right.

Phoebe W. Brown
Secretary

cc: Lawrence J. Zweifach, Esq.
Michael Plotnick, Esq.
William F. Ryan, Esq.



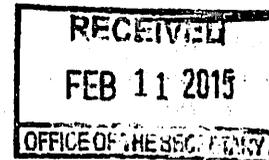
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

_____)
)
In the Matter of Mark E. Laccetti, CPA,)
)
Respondent)
)
_____)

PCAOB File No. 105-2009-007

FINAL DECISION

January 26, 2015



Appearances

Michael Plotnick, Esq., William F. Ryan, Esq., and Philip J. Berkowitz, Esq.,
Washington, DC, for the Division of Enforcement and Investigations

Lawrence J. Zweifach, Esq., Michael J. Scanlon, Esq., and Darcy C. Harris, Esq.,
Gibson, Dunn & Crutcher LLP, Washington, DC, for Respondent

I.

In this disciplinary proceeding, Respondent Mark E. Laccetti is charged with violating PCAOB rules and auditing standards in connection with the audit of a foreign private issuer's consolidated financial statements for the year ending December 31, 2004. The auditor of those financial statements assigned part of the audit—the audit of the issuer's United States subsidiary—to another independent auditor, with which Laccetti was associated. Laccetti served as the auditor with final responsibility for the audit of that subsidiary. The subsidiary, like its parent, recognized revenue at the time its products were sold, and, in undertaking to comply with United States generally accepted accounting principles, estimated, deducted from sales, and recorded in accounts receivable reserves, the amounts it expected to incur on those sales for various sales incentives it offered to its customers. Laccetti is charged with failure to exercise due professional care, including professional skepticism, with failure to obtain sufficient competent audit evidence, and with certain other violations, concerning the audit work on these reserves in total and for the largest sales discount, chargebacks. The parent company later restated its financial statements for 2004 and other periods, principally due to the subsidiary's erroneously low chargebacks estimates, which had caused multi-million-dollar overstatements of net sales and related receivables.

After holding a hearing, the hearing officer issued an initial decision finding that the Division of Enforcement and Investigations had proven certain, but not other, of the alleged violations against Laccetti by a preponderance of the evidence. The initial decision imposed the sanctions of a six-month suspension from association with any registered public accounting firm and a \$25,000 civil money penalty for the violations found, and otherwise dismissed the case against Laccetti. Laccetti petitions for review

of the decision's admission of certain evidence, its disposition of the charges on which sanctions were imposed, and the sanctions. The Division petitions for review of the hearing officer's exclusion of certain evidence, the initial decision's disposition of all but one of the charges it dismissed, and its determination of sanctions.

We have reviewed the record in this case *de novo*, except as to those findings not challenged on appeal, in light of the briefs and oral argument presented to us. We find that Laccetti violated PCAOB rules and auditing standards, with respect to audit work for which he was responsible on the United States subsidiary's total, year-end 2004 accounts receivable reserves. He did so by failing to exercise due professional care, failing to obtain sufficient audit evidence, failing to adequately perform procedures to evaluate the reasonableness of a significant accounting estimate, and improperly relying on management representations. We further find that this conduct, along with the failure to perform an audit procedure to review the estimate for biases that could result in material misstatement due to fraud, was reckless, or, at a minimum, repeatedly negligent, we bar Laccetti from associating with a registered public accounting firm, provided that he may petition the Board to associate with such a firm after two years, and we order him to pay an \$85,000 civil money penalty.

II.

On October 20, 2009, the Board issued an Order Instituting Disciplinary Proceedings (OIP) alleging violations of PCAOB rules and auditing standards by Mark E. Laccetti, in auditing the 2004 financial data of Taro Pharmaceutical U.S.A., Inc., a subsidiary of Taro Pharmaceutical Industries Ltd. The audit of this subsidiary was conducted in connection with another independent auditor's issuance of an audit report on the 2004 consolidated financial statements of the parent company. At all relevant times, the parent company was an issuer, as defined by Section 2(a)(7) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201(7), and PCAOB rules, and Laccetti was a person associated with a registered public accounting firm—Ernst & Young LLP—as defined by Section 2(a)(9) of the Act, 15 U.S.C. 7201(9), and PCAOB rules. Laccetti filed his Answer on December 7, 2009. Following nine days of hearings in June and July 2010, the hearing officer issued the initial decision on April 20, 2011. The Division and Laccetti both petitioned for review of the decision. Briefing concluded on October 25, 2011. The Board heard oral argument in the case on March 13, 2012.

III.

Based on our review of the record, we find the facts to be as follows.^{1/}

^{1/} In light of ample other evidence presented in this proceeding, we need not, and do not, rely on any of the materials whose admission into, or exclusion from, evidence is

A. Laccetti Was the Auditor With Final Responsibility for the 2004 Audit of a United States Pharmaceutical Company, a Major Subsidiary of an Israel-Based Issuer Audited by Another Independent Auditor.

Laccetti was the auditor with final responsibility, or engagement partner, for Ernst & Young's audit of the financial information of Taro Pharmaceutical U.S.A., Inc. (Taro USA) for the year ending December 31, 2004. See, e.g., AU §§ 230.06, 311.02, 316.74. He had been associated with Ernst & Young since 1989, had joined the Taro USA engagement in January 2004, as senior manager on the 2003 audit, and had been promoted to partner in July 2004. Hearing Exhibit (Ex.) L-108 at 3; Index to the Record on Review, Record Document (R.D.) 135 at 195-96, 241 & R.D. 137 at 661, 667, 672, 703 (Laccetti). Other than Laccetti, the 2004 Taro USA audit team was effectively new to the engagement, consisting of a senior manager and a staff accountant who served as "acting senior" auditor. Ex. J-4 at 22; R.D. 137 at 706-08, R.D. 139a at 1009-11.

Taro USA was the United States subsidiary of Taro Pharmaceutical Industries Ltd. (parent company), a multinational company, based in Israel, that developed, manufactured, and marketed pharmaceutical products. During the relevant period, Taro USA did not issue financial statements, but its parent company issued audited annual financial statements on a consolidated basis, incorporating its subsidiaries' financial information. As a foreign private issuer, the parent company filed annual reports on Form 20-F, including its financial statements, with the United States Securities and Exchange Commission (SEC or Commission), and its stock was publicly traded in the United States on the NASDAQ National Market. The parent company was not required to file quarterly reports, but it did issue press releases about its quarterly financial results, and its audit committee chairman had asked its auditor to arrange for Ernst & Young to perform limited quarterly reviews of Taro USA. R.D. 141 at 1497-1501.

As with prior-year audits of Taro USA, the audit for 2004 had been assigned to Ernst & Young by another independent auditor, an Israeli firm, which served as the principal auditor of the parent company's consolidated financial statements. See AU § 543, *Part of Audit Performed by Other Independent Auditors*. The principal auditor's September 2004 engagement instructions directed Ernst & Young to perform a "full scope US GAAP [generally accepted accounting principles] and GAAS [generally accepted auditing standards] audit on the trial balances" in Taro USA's "reporting package" of its financial information for 2004, including its balance sheet and statement of income. Ex. J-2 at 1, 7, 9, 19; Ex. J-26 at 6, 8, 20; Ex. D-72 at 3; R.D. 139a at 1070-71 (principal auditor's engagement partner); R.D. 135 at 231-34, R.D. 137 at 677 (Laccetti); see Ex. D-126 at 1. It is undisputed that this required an audit conducted in accordance with PCAOB standards. Initial Decision (I.D.) 20, 35; see, e.g., Ex. J-17 at

challenged before us by the parties, nor do we rely on Laccetti's investigative testimony. See Sections VI(A), VI(B), and VII(A) below.

102; Ex. R-12 at 7 (Taro USA letter to Ernst & Young); R.D. 141 at 1520-21 (principal auditor's engagement partner). Laccetti understood that the principal auditor planned to use the 2004 Taro USA audit work in its audit of the parent company's 2004 consolidated financial statements, included in Form 20-F to be filed with the SEC. Ex. D-72 at 3; see Ex. D-126 at 1-2; R.D. 139a at 985 (Laccetti). The principal auditor issued an unqualified opinion on those financial statements. Ex. J-17 at 102.

Taro USA sold mainly generic, but also some branded, pharmaceutical products. Its customers were primarily large wholesale drug companies. In 2002, 2003, and 2004, its three largest wholesale customers contributed around 40% or more of the parent company's consolidated sales. Ex. J-1 at 35; Ex. J-17 at 33. Taro USA sold to wholesalers subject to various adjustments to the price of sales, including chargebacks, rebates, billbacks, and return rights. In Forms 20-F for 2003 and 2004, the parent company made clear, on behalf of itself and its subsidiaries, that "[t]he pharmaceutical industry in which we operate is intensely competitive," "[w]e are particularly subject to the risks of competition," "[t]he nature of our business requires us to estimate future charges against wholesaler accounts receivable," and sales incentives (or allowances) were used to promote sales in this competitive market. Ex. J-1 at 9, 15, 36, 38, 46, 47; Ex. J-17 at 8, 14, 34, 36, 41, 42; see R.D. 137 at 749-52 (Laccetti).

The wholesalers, in turn, sold the products to drug stores, hospitals, and other health care providers. A wholesaler was entitled to a chargeback when it sold a Taro USA product to a customer who had an agreement directly with Taro USA to buy such products at specified prices that were less than the gross sales amounts that Taro USA charged the wholesaler (wholesale acquisition cost or WAC). By agreement, the wholesaler would sell the product to the customer at the specified price and then submit a chargeback to Taro USA for the difference between that price and the WAC.

Taro USA's parent company reported that it prepared its financial statements in accordance with United States generally accepted accounting principles (GAAP). Ex. J-1 at 3, 47, 118; Ex. J-17 at 3, 44, 116; see Ex. J-26 at 5. Taro USA, like its parent, recognized revenue from product sales "when the merchandise [was] shipped to an unrelated third party," rather than when payment was received. Ex. D-63 at 5 (2004 Taro USA audit work paper); see Ex. J-1 at 47; Ex. J-17 at 43-44. In doing so, Taro USA represented, among other things, that the selling price of its products was fixed or determinable and that it could reasonably estimate the sales allowances it would incur on the sales, consistent with Statement of Financial Accounting Standards (FAS or SFAS) No. 48, *Revenue Recognition When Right of Return Exists*, ¶ 6, and SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. R.D. 135 at 204, R.D. 137 at 506-07 (Laccetti); Ex. D-63 at 5; see Ex. J-1 at 121, 125; Ex. J-17 at 44, 116.

Accordingly, Taro USA estimated, deducted from sales, and recorded in accounts receivable reserve accounts the amounts of sales allowances, such as chargebacks, rebates, billbacks, and return rights, it expected to incur on those sales.

Ex. D-63 at 5; Ex. L-22 at 17-22; see Ex. J-1 at 47; Ex. J-17 at 43. Those sales adjustments contributed substantially to reducing the parent company's gross sales to the reported net sales on its Consolidated Statement of Income and, at the same time, to reducing the parent company's gross accounts receivable to the net accounts receivable reported on its Consolidated Balance Sheet. In 2002, 2003, and 2004, Taro USA contributed more than 85% of the consolidated net sales, more than 90% of the year-end consolidated net accounts receivable, and more than 90% of the year-end consolidated accounts receivable reserves reported by the parent company. Ex. J-1 at 34, 109 (Form 20-F for 2003); Ex. J-17 at 33, 45, 103 (Form 20-F for 2004); Ex. D-278 at 3; Ex. D-294 at 4; Ex. L-22 at 8. In 2004, Taro USA's gross sales totaled approximately \$580 million and were reduced, by the various sales allowances, to net sales of about \$248 million, which were consolidated into the parent company's total reported revenue of about \$284 million. Ex. L-22 at 14-15; Ex. J-17 at 33, 105.

Compared to 2003, Taro USA's 2004 gross sales rose by \$28 million and its year-end 2004 gross accounts receivable grew by nearly \$12 million to \$165 million. By contrast, year-end accounts receivable reserves rose by only \$1 million to \$42 million. Ex. L-22 at 2. Certain audit testing showed that, on average, Taro USA's receivables were going unpaid significantly longer in 2004 than in 2003, which could indicate a problem with the reserves. *E.g., id.* at 8; R.D. 139a at 923-25; R.D. 180 at 86.

In 2004, as in 2003, chargebacks represented the largest sales allowance reflected in Taro USA's and its parent's financial data. Ex. L-22 at 14-15; Ex. D-294 at 1, 4; Ex. J-17 at 45. Taro USA did not prepare a detailed calculation or specific estimate to support its year-end 2004 chargebacks reserve, as it did for its other sales allowance reserves, and, unlike the others, Laccetti assessed chargebacks as a component of accounts receivable reserves in total, rather than individually. Ex. L-22 at 20, 22. Despite higher recorded gross sales, sales adjustments, and year-end gross receivables and reserves in 2004, the chargebacks reserve fell by 87%, to \$2.37 million, from the largest component of the reserves in 2003 to one of the smallest. *Id.* at 2.

B. In Planning the 2004 Taro USA Audit, Laccetti Knew That the Company's Processes for Estimating Sales Allowances Had Not Been Strong and Understood That the Audit Needed To Focus on the Related High-Risk Areas of Revenue Recognition and Accounts Receivable Allowances.

Laccetti led the planning of the 2004 Taro USA audit. R.D. 137 at 775-76. In doing so, he recognized that accounts receivable allowances was an area of high risk and focus in the audit. R.D. 135 at 273-74; R.D. 139a at 971-72. He knew that, after the 2002 and 2003 audits, the principal auditor had commented to Taro USA's parent company, with Ernst & Young's input, that Taro USA lacked a formalized methodology for preparing and reviewing accounts receivable allowance estimates and had suggested improvements. R.D. 137 at 799-801, 813-14; Exs. J-27 at 4, D-21 at 3, and D-18 at 2 (management letters from the auditors). He also knew going into the 2004

audit that, just the year before, the Ernst & Young audit team, to which he belonged, had increased the combined risk assessment for Taro USA's valuation assertion of accounts receivable allowances from moderate to high. R.D. 135 at 216; Ex. D-3 at 7.

The principal auditor's engagement instructions for the 2004 Taro USA audit identified "revenue recognition" as an area of "primary importance" and stated, "Special attention should be given to allowance for rebates, discounts and returns," a directive that included chargebacks. Ex. J-26 at 30; see R.D. 141 at 1528 (principal auditor's engagement partner). The instructions also informed Laccetti that "accounts receivables and revenue recognition (including allowance for rebates, discounts and returns)" would, along with several other areas, be the principal auditor's "emphasis during the audit" of the parent company, "[d]ue to [certain] changes" in "significant accounting and audit issues" from 2003. Ex. J-26 at 3. The instructions pointed out several such changes, two of note here. The first was that customers had "withheld from payment" to Taro USA approximately \$20 million "in error" as sales allowances, that Taro USA had included this amount in accounts receivable as of March 31, 2004, and that \$16 million remained unpaid as of June 30, 2004. The parent company "believes that these amounts were withheld in error and that substantially all of these errors will be rectified in due course." *Id.* The second, described as a "material change in business," was "a substantial decrease in [the parent company's consolidated] sales," leading to "a loss of \$8.9 million in the second quarter of 2004," a drop in share price "to \$20 from average price of \$60," and the filing of "several class action lawsuits against [its] management." *Id.* at 3, 6; see Ex. J-29 at 7. This was largely due to Taro USA's results. *E.g.*, Ex. D-72 at 3-4. Before year-end 2004, Laccetti signed and returned to the principal auditor the acknowledgement forms in the instructions. Ex. J-26 at 14-18.

Laccetti led the preparation of various audit planning documents. One was an Audit Strategies Memorandum, which, after input from the principal auditor, was finalized on January 5, 2005. Ex. D-72; R.D. 139a at 882-83, 980-81. It discussed "Significant Accounting and Auditing Issues" involved in the Taro USA audit and set forth a plan for the audit. Another, provided to the principal auditor along with that memorandum, was an Internal Control and Fraud Considerations form identifying certain fraud risks and audit responses. *Id.* at 883-85; Ex. J-29. And another was the Preliminary Audit Strategy by Significant Account document (Ex. D-74), "an overview of our preliminary audit strategy for each significant account" (Ex. D-72 at 10).

The Audit Strategies Memorandum discussed the roughly \$20 million that, in the parent company's view, had been erroneously withheld from payment to Taro USA by wholesalers, to which reference was made in the engagement instructions. Of note here, the memorandum stated that around \$11 million, representing chargebacks Taro USA calculated it had "erroneously returned to the wholesalers" and "expects to collect," still remained unrepaid. Ex. D-72 at 5. The document explained that Taro USA's error resulted from basing the chargebacks on the increased wholesale acquisition cost, or WAC, charged by the company to the wholesalers as of July 1, 2003, when, in fact, the

wholesalers had purchased some of the product at issue at the lower WAC in effect before July 1, 2003. *Id.* at 4-5. Taro USA had discovered its mistake in the first quarter of 2004, “as cash decreased and the chargeback’s reserve decreased.” *Id.* at 5. An audit work paper noted the excess chargebacks had been taken by the three largest wholesalers and Taro USA had “requested on May 27, 2004 that the difference be returned.” Ex. L-22 at 3. According to the Audit Strategies Memorandum, Taro USA calculated the “over-chargeback’s” by “estimat[ing] the amount of inventory held by the wholesalers at July 1 to be equal to the purchases from the prior six months.” Ex. D-72 at 5. Taro USA “has increased accounts receivable for the entire \$11 million and has also reserved the entire amount” of that increase. *Id.* Later in the audit, Laccetti learned that Taro USA maintained the \$11 million receivable, but not any reserve for it, at year end 2004. *E.g.*, Ex. D-88 at 3; Ex. D-234 at 2; Ex. R-12 at 3; R.D. 139a at 1020.

The Audit Strategies Memorandum also spoke to the decrease in second quarter 2004 sales referenced in the engagement instructions. It stated that Taro USA halved or eliminated during that quarter a promotional discount of 10% offered to wholesalers on all products. Ex. D-72 at 3. This caused “a large decrease” in Taro USA’s second-quarter sales, as the wholesalers “reduced their sales orders and operated off of the inventory on hand.” *Id.* at 4. But, “as wholesalers inventories depleted,” Taro USA’s sales “began to recover,” with third quarter 2004 sales “show[ing] a positive trend in the sales of most products.” *Id.* Laccetti cited this recovery of sales when the principal auditor asked, in commenting on the draft memorandum, about how the second-quarter sales decline was consistent with the team’s “analytical review where you state that promotional discounts increased during 2004.” *Id.* at 3. See Ex. J-29 at 7.

Regarding the audit plan, the memorandum stated that the “nature, timing, and extent of our planned audit procedures have been developed in response to the combined risk assessment for each significant account.” Ex. D-72 at 10. It identified “[a]ccounts receivable allowances” as one of five separate Taro USA accounts for which the valuation assertion was of “higher inherent risk” and among the four of these accounts for which this assessment was “due to the inherent subjectivity in the estimations processes.” *Id.* at 9. Noting that the “[n]ature of A/R allowances is such that significant estimation is used,” the Preliminary Audit Strategy document identified “Accounts Receivable Allowances” and “Sales” as significant accounts, each with “higher” inherent risk, “maximum” control risk, and “high” combined risk as to valuation. Ex. L-1 at 3; Ex. D-75 at 1; Ex. D-63 at 6 (combined risk assessment for valuation and measurement of revenue was “High”). See R.D. 135 at 321 (Laccetti).

As to fraud risks, the Internal Control and Fraud Considerations document specified “[i]mproper revenue recognition” and “[m]anipulating significant accounting estimates,” including “accounts receivable allowances,” as one of three “Identified Fraud Risks.” Ex. J-29 at 6. It observed that Taro USA “is subject to significant pricing pressures and low margins” relating to generic pharmaceuticals that “creates pressure on meeting sales goals” and “could lead to improper revenue recognition,” and noted

that “[m]anagement’s estimation processes for accounting estimates have historically not been strong.” *Id.* In addition, the document indicated that “[i]neffective accounting and information systems” was a “risk factor[] to be considered relating to opportunities associated with misstatements arising from fraudulent financial reporting.” *Id.* at 27. Although the document also stated that, while “[r]ecent improvements have been made to the accounts receivable allowance estimation process,” this “still remains an area of significant subjectivity” (*id.* at 6), Laccetti testified that he was not aware during the 2004 audit of any such improvements having been made, that this language was directly carried over from the Internal Control and Fraud Considerations document for the prior year’s audit of Taro USA, and that he could not remember having been aware of any recent improvements during the 2003 audit either. R.D. 135 at 281-82. By contrast to the allowances, the audit team’s combined risk assessment for gross accounts receivable was “Minimal,” and the auditors did not identify fraud risks for that account. Ex. L-1 at 1; Ex. L-22 at 1636.

The Ernst & Young audit team did not plan to perform substantive procedures specifically to test the estimates of items that reduced gross sales to net sales on Taro USA’s income statement because the team instead would rely on testing with respect to the balance sheet. R.D. 135 at 322 (Laccetti). Moreover, in the accounts receivable allowances area, the audit team planned to perform substantive procedures and not to rely on testing of internal controls, which the team determined were ineffective. Ex. L-1 at 3; R.D. 135 at 315-17 (Laccetti); R.D. 137 at 523-24 (same); see R.D. 135 at 283-86.

The audit team stated that to address the risks identified in the Audit Strategies Memorandum, it would “review the client’s [accounts receivable] reserves and methodology in detail” and “perform substantive procedures on the allowances at year-end,” and specifically it would “perform procedures to determine the reasonableness” of 14 listed “allowances and rebates,” including chargebacks. Ex. D-72 at 6. To this end, management would provide the audit team with “an analysis of the allowances, which will include an analysis of the overall realization of accounts receivable (cash collections as a percentage of gross accounts receivable).” *Id.* The Preliminary Audit Strategy document specified that the team would “[o]btain an understanding of how” each of certain sales allowances, including chargebacks, “is established and evaluate whether this method is adequate,” as well as “[r]eview the overall reserve calculation as of December 31 and the related accounts.” Ex. D-74 at 2, 3.

Regarding chargebacks, in particular, the audit plan was to: (1) “[c]ompare the allowance for chargebacks with that of prior periods and investigate any unexpected changes (or the absence of expected changes)”; (2) “[d]etermine reasonableness of reserve for chargebacks by calculating chargebacks as a percentage of sales and analyzing trend of chargebacks using the September and December aging and the most recent aging”; (3) “[o]n a test basis compare amounts accrued to contracts for reasonableness”; and (4) “[r]eview charge-backs > 25% of TE [tolerable error] that occurred subsequent to year end to determine if they related to the receivable balance

as of December 31," in addition to more generally "[p]erform[ing] a search for all credits issued subsequent to year end exceeding 25% of TE to assure proper allowances have been established." Ex. L-1 at 5-7; see Ex. D-46 at 48-49; R.D. 135 at 327-30.^{2/}

To address the identified fraud risk of improper revenue recognition, the audit team wrote that it planned to, among other things, "[p]erform detailed and analytical review procedures on significant accounting estimates related to revenues." Ex. J-29 at 8. In particular, the team set forth three planned audit responses to the fraud risk relating to biases in significant accounting estimates: (1) "[p]erform detail testing and analytical review procedures, including hindsight review, of all significant accounting estimates"; (2) "[d]ocument our understanding of the client's processes and determine whether there appears to be any management bias"; and (3) "[d]etermine whether management is consistently recording estimates." *Id.*

C. Laccetti Faced a Process Deficiency in Taro USA's Estimation of Sales Allowances, Difficulty Obtaining Information and Analysis To Support the Year-End Reserves, and Cause for Concern About the Reserves.

During the 2004 Taro USA audit, Laccetti encountered what he determined to be a process deficiency in the company's estimation of its sales allowances, which, as noted, the company recorded both as deductions to sales and as accounts receivable reserves; difficulty in obtaining information and analysis to support Taro USA's year-end 2004 accounts receivable reserves; and audit evidence that raised concerns about the reserves. At the time of the audit, Laccetti summarized these circumstances by stating, "Due to the fact that the Company can not give us lag reports related to subsequent cash receipts or accounts receivable allowances and the fact that they have no formal methodology to test, it is difficult to review appropriateness of allowance without looking at trends and specific accounts." Ex. D-100 at 1-2. On February 8, 2005, several days after the original deadline for completing the field work for the 2004 audit, he reported to the principal auditor that the audit team's accounts receivable analysis was not favorable, that the team was not comfortable that the accounts receivable were fairly stated, and that this message had been conveyed to Taro USA. Ex. D-87 at 1. Even

^{2/} The principal auditor set tolerable error at \$360,000 for the Taro USA audit. Ex. J-26 at 6; Ex. D-72 at 10; Ex. D-126 at 1; Ex. L-22 at 1636; R.D. 135 at 233-34. Tolerable error or "tolerable misstatement" is "a planning concept and is related to the auditor's preliminary judgments about materiality levels in such a way that tolerable misstatement, combined for the entire audit plan, does not exceed those estimates." AU § 350.18, .48. The engagement instructions explained that tolerable error "has been assigned to each [subsidiary] based upon the overall size of the [subsidiary] and the risk of financial statement misstatement as determined by the [principal auditor's audit team]. The TE assigned is to be used at each Location as a starting point for establishing testing thresholds/scopes." Ex. J-26 at 6; see R.D. 139a at 1075-78.

when Laccetti expressed ultimate satisfaction with the allowances in a February 18, 2005 draft memorandum to the principal auditor, the principal auditor's engagement partner sensed hesitancy on Laccetti's part. Ex. D-100; R.D. 140a at 1284-85.

1. Laccetti found Taro USA had a deficient process for preparing and reviewing accounts receivable allowance estimates.

Laccetti discussed Taro USA's process deficiency with the principal auditor's engagement partner during February and March 2005. The Israeli partner's notes of February 10, 2005 discussions with Laccetti state, "No orderly process" and "Issue with allowances" or, alternatively, "There is no organized process. It might be a problem, it might be issues with reserves." Ex. D-89; R.D. 139a at 1130. The partner's notes of the discussions explain that "there is a problem with monitoring the reserves that should be made. There are no formalized procedures and no structured process for evaluating the required level of reserves. Part of the problem stems from a lack of information about the stock levels at the wholesalers." Ex. D-91; Ex. D-234 at 1 (translation). Laccetti knew that inventory levels in the hands of the wholesalers was a factor that should be taken into account in considering Taro USA's ability to reasonably estimate accounts receivable allowances. Ex. J-27 at 4; R.D. 135 at 207 (Laccetti). And he understood that Taro USA's current agreements with wholesalers did not "give[] information about the stock levels [of its products] at the wholesalers." Ex. D-234 at 2.

Indeed, on January 26, 2005, Laccetti had reviewed and included in the audit work papers a December 17, 2004 letter to SEC staff from Taro USA's parent company, which stressed subjectivity in the estimates of account receivable allowances and indicated limitations on access to information about the wholesale customers' inventory levels. R.D. 135 at 261-63, 266-67; see Ex. D-44 at 3. The letter responded to a November 24, 2004 letter from SEC staff suggesting that the parent company's description of its revenue recognition practices in the "Critical Accounting Policies" section of its Form 20-F for 2003 could be improved by adding certain disclosures. Ex. D-37. The response letter represented, "We determine the amounts to accrue and reserve subjectively, on the basis of our decades-long historical experience rather than on the basis of any particular or quantifiable objective assumptions." Consequently, the letter stated, "there are no (i) 'other reasonably likely assumptions' on the basis of which we might determine the amount of our accruals and reserves differently or (ii) objective criteria that we could alter in order to perform a sensitivity analysis." It also represented that "the substantially most determinative factor that we consider in establishing accruals and reserves is our historical experience." According to the parent company, "We have no way of knowing or reasonably estimating (i) the actual levels of inventory in our distribution channels or (ii) the then-current inventory policies, or desired inventory levels, of our distributors. Because we do not know, and cannot reasonably estimate, either the amount or the age of our distributors' inventories, we are also unable to estimate remaining shelf lives, except on the basis of our historical experience." The letter emphasized that the company's sales allowance estimates are

"based primarily upon historical amounts of Sales Allowances, rather than the causes of such Sales Allowances." Ex. D-44 at 3-4 (emphasis in original).^{3/}

In a February 13, 2005 email, the principal auditor's engagement partner raised with Laccetti the prospect that additional accounts receivable reserves might need to be recorded and "a material weakness under SAS 60" noted. Ex. J-5 at 1-2. In response, Laccetti referred to the issue as "a lack of a process for establishing an AR reserve" and stated that "[u]nless we conclude that the AR reserves need to be adjusted," the "AR reserve process" "should be noted as [a] reportable condition[]." *Id.* at 1.^{4/}

In the draft Summary Review Memorandum, sent to the principal auditor on February 18, 2005, Laccetti described the deficiency in the following terms: "We noted

^{3/} The SEC staff wrote to the parent company again on March 24, 2005, stating again that its "disclosure related to estimates of items that reduce gross revenue such as product returns, chargebacks, customer rebates and other discounts and allowances are material and could be improved," questioning "why you believe you have met the conditions of paragraphs 6 and 8 from SFAS 48, such that you recognize revenue at time of receipt by wholesalers," and asking it to "revise the financial statements or more fully disclose how your revenue recognition complies with SFAS 48 and SAB 104." Ex. D-294 at 3, 5. A new response, copied to Laccetti for comment on May 23 (Ex. D-294) and discussed in a May 26, 2005 conference call that included the principal auditor's engagement partner and Laccetti (R.D. 141 at 1758), expanded on the parent company's prior letter. In particular, the company's new letter stated it "would like to make the following clarification" as to "the actual levels of inventory in the distribution channel": "While we are not provided with detailed inventory reports directly by our customers, we monitor inventory in the channels based on customers' orders, customers' submissions of their sales to third parties, third party reports of prescriptions written, third party sales data, and our experience and historical data, including the amounts and levels of actual returns and rebates." Ex. D-294 at 6.

^{4/} Statement on Auditing Standards (SAS) 60 defined a reportable condition as a matter coming to the auditor's attention during the audit that, "in his judgment, should be communicated to the audit committee because [it] represent[s] significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements." SAS 60 noted that a reportable condition "may be of such magnitude as to be considered a material weakness," which it defined as "a reportable condition in which the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions."

that [Taro USA's] accounts receivable reserve process is not done in a timely manner and the estimation methodology has not been defined and monitored for the most updated trends. We consider this deficiency to be a reportable condition, which...will need to be addressed as the Company prepares for Section 404 [of the Sarbanes-Oxley Act, 15 U.S.C. 7262.] reporting in 2005. This reportable condition should be communicated to the Audit Committee." Ex. J-6 at 5; see Ex. D-54 at 6 (Taro USA audit team's February 24, 2005 Accounts Receivable Allowances Memorandum, also sent to the principal auditor: "We will provide a management letter comment concerning the estimation process used as they relate to account receivable allowances.").

On March 3, 2005, Laccetti indicated his view of the difficulty that the process deficiency had presented for the Taro USA audit, when the Israeli partner asked him to clarify the above description, in advance of a March 8, 2005 meeting with the audit committee. The Israeli partner asked, "I just wanted to make sure that when you said in a timely manner you mean that [Taro USA's accounts receivable] process is not done on a periodic basis. The [chief financial officer] had the idea that you meant that when you started the audit it was still not prepared." Ex. D-117 at 2. Laccetti responded:

The main issue is they have no method[o]logy or process for making a sound estimate of AR allowances. I believe we did receive some information late in the audit process, but the bigger issue is the fact that we s[p]ent the whole audit trying to justify a number as they had no methodology for us to audit. They do book allowances through-out the year, so that is not really the issue, the issue is they have no real basis for the amounts they record. If timely is an issue I have no issue with dropping the reference to timely.

Id. at 1; see Ex. D-114 at 1 (March 3, 2005 email from Laccetti to senior manager of Taro USA audit about Israeli partner's question "related to timeliness of the ar process," stating, "To me more of the issue is that they have no process for creating an estimate."); Ex. D-115 (in response to Laccetti, senior manager wrote, "It relates to not having a timely or adequate process for creating an estimate.").^{5/}

^{5/} A further exchange took place on March 29, 2005, when the Israeli partner asked Laccetti for his reaction to the company's request to "change the wording" of certain audit findings that the principal auditor had based on Laccetti's description of the deficiency and planned to include in "the audit results presentation to Audit Committee." Ex. J-23. As to accounts receivable allowances, the company wanted to replace certain language—"We noted that [Taro USA's] accounts receivable reserve process is not done in a proper manner. The estimation methodology has not been defined and monitored for the most updated trends."—with "We noted that [Taro USA's] accounts receivable reserve process is not done in an efficient manner and the estimation

Also in March 2005, Laccetti reviewed and edited a comment, finding, and recommendation about the process deficiency, for inclusion, along with other points, in the principal auditor's management letter to Taro USA's parent company for the audit of the 2004 consolidated financial statements. Ex. J-25. As pertinent here, the document described the deficiency as a reportable condition and stated that:

During our audit we determined that management did not have a formalized process in place for estimating reserves (i.e.,] doubtful accounts, bill-backs, returns, rebates, discounts, charge-backs, etc....) for accounts receivable. In addition, timely preparations of reserve schedules were not given to us in a timely manner, delaying the timing of our audit procedures.

....Formal policies would establish a consistent method for determining the allowances and also assist management in providing monitoring information for review and control of the accounts receivable.

The use of a consistent methodology would provide a basis for monitoring customer trends and performance by line of business as well as monitor the effectiveness of the Company's credit and collection practices. The assumptions used in the method should be evaluated each year against actual data to determine whether they remain appropriate.

In addition, the company should review the year end audit list that is sent by E & Y to ensure that all schedules requested are prepared in a timely manner and will not delay audit procedures.

Id. at 1, 2-3; R.D. 139a at 954-56.

2. Laccetti had difficulty obtaining data and analysis about the year-end allowance reserve and was concerned about its adequacy.

On February 1, 2005, days before the deadline for completion of the field work on the 2004 Taro USA audit, Laccetti had not yet received various items from Taro USA, including a final trial balance "as it relates to the significant account[] of Accounts receivable." Ex. D-87 at 2 (senior manager email); see Ex. D-34 at 2; R.D. 137 at 717-21 (Laccetti). Laccetti met with management on February 4, 2005, in part to discuss issues pertaining to accounts receivable reserves, including several prepared schedules—an Accounts Receivable Summary for 2001 to 2004; a Sales Allowance Analysis for 2004; and a Cash Collections sheet for 2003 and 2004. Exs. D-79 at 2-3, 6, 7, D-80, D-81. At that time, Laccetti shared with Taro USA an accounts receivable

methodology has not been defined." Laccetti commented, "I think th[eir] change still gets the substance of the comment across, so I am OK with their re-write." *Id.* at 1-2.

analysis, described as follows in his testimony: "in performing our initial procedures and looking at the trends," including "the trend of the days sales [in] receivables," "it wasn't what we were expecting." R.D. 135 at 409-10, R.D. 139a at 1012-13; Ex. D-87 at 1.

Days sales outstanding or days sales in accounts receivable (DSR) is a calculation of the average number of days for payment to be made on a company's sales. R.D. 135 at 260, R.D. 139a at 923-24. The audit team calculated DSR based on net accounts receivable (either the period-end figure or the average of that figure with net accounts receivable from the end of the prior period under comparison), divided by net sales for the period, and then multiplied by 360 days. See, e.g., Ex. L-22 at 8. The team used DSR "to test the adequacy of [accounts receivable] reserves in total." Ex. L-22 at 22. Taro USA's rising DSR in 2004 had been a topic of conversation at the initial planning stages of the 2004 Taro USA audit. Ex. L-181 at 7-9, 14 (senior manager's investigative testimony). The Accounts Receivable Summary showed DSR rising from 110.99 days in 2003 to 170.84 days in 2004. Ex. D-79 at 2; see Ex. L-22 at 8.

In response to Laccetti's analysis, as reported in his and the senior manager's emails, Taro USA stated that it was investigating "some accounts receivable schedules that we have not received yet but are expected to receive [on February 7]," stated that it was "preparing some additional analysis for us," and "asked us to do some additional analysis from [a] different perspective." Exs. D-80, D-87 at 1. In a February 7 email, sent in draft and copied in final to Laccetti, to keep the principal auditor "informed of our progress and th[e] problems that we are dealing with," the senior manager wrote that "our optimistic plan is to finalize these issues this week (provided we get [Taro USA's] full cooperation and the appropriate analysis of these issues)[.]" Exs. D-80, D-81.

The resulting quarterly 2004 Accounts Receivable Summary showed, according to an email later on February 7 from the senior manager to Laccetti, that "days in A/R are continuing to increase each quarter. I don't think this makes the picture any better for [Taro USA]." Ex. D-82 at 1, 4-5. The email further stated that "I also decided to breakout the quarterly cash collected to see how this compared to gross sales and this indicated that the 4th quarter was not good. In addition, I put together a lag analysis using the assumption that it takes 110 days to collect the average receivable. This basically shows that there is still \$48 million in outstanding receivables as of December 31, 2004 that do not relate to current quarter (older receivables)." Ex. D-82 at 1, 6 (attaching a Gross/Net Sales and Cash collection analysis, containing the breakout and comparison of cash collections and the lag analysis). A note on Laccetti's agenda for the February 4 meeting had stated, "QTRLY cash collection look." Ex. D-79 at 1.^{6/}

^{6/} Another note by Laccetti on that agenda stated, "QTRLY look @ divisional sales." Ex. D-79 at 1. The audit work papers indicate that Taro USA grouped its sales by several divisions, one of which sold "Branded RX" (prescription) products. Ex. L-22 at 8-11; Ex. D-63 at 59-62. A revenue work paper, "Gross sales by product," listed 2003

On February 8, 2005, the senior manager talked to Taro USA "about the quarterly data" and provided "an analysis on the last 5 months of cash collections which was not good," showing that it would take 244.34 days to collect the "A/R balance at 12/31/04," based on dividing year-end 2004 net accounts receivable by the average monthly collections for September 2004 through January 2005. Exs. D-83 at 1, 7, D-85 (senior manager's emails that day to Laccetti, attaching the analysis). The Gross/Net Sales and Cash collection sheet reflected an additional 2004 DSR calculation of 191.48 days based on dividing year-end net accounts receivable by cash collections and multiplying by 360 days, up from 168.39 days in 2003. Ex. D-82 at 6. The principal auditor's engagement partner, after talking with Laccetti around the same time, wrote, "There is a growth in the number of days of credit and in the sum of the customer debts, but there is no corresponding growth in the various reserves." Ex. D-91 (notes); Ex. D-234 at 1 (translation). The senior manager wrote to the company on February 8: "The days outstanding are high and the recent cash collections have not been great. Based on the analysis we need to consider if you are adequately reserved." Ex. D-84 at 1.

In addition, the senior manager created and sent to Laccetti and Taro USA a "pivot table by customer with the aging balances" reflected on the company's "detailed" "12/31/04 aging" report, for use in "identify[ing] aged items by customer" and "analyzing [its] A/R for adequate reserves." Exs. D-82, D-84 (February 7-8 emails); see Ex. L-23 at 2132-48 (table was included in the work papers); R.D. 139a at 997-98 (Laccetti). The senior manager wrote to Laccetti at the time that "the aging report show[ed] over \$7 million in outstanding A/R and I have not received any answers back yet." Ex. D-85.

Late on February 8, 2005, Laccetti wrote to the principal auditor, "Our accounts receivable analysis is not favorable. We shared our analysis with [Taro USA's Vice President of Finance] last week and he asked us to do some additional analysis from [a] different p[er]spective. We have done what he requested with no change in the result." Ex. D-87 at 1; see R.D. 137 at 683. Further, "We have presented all of the analysis to the Company with the current position that we are not comfortable that the accounts

and 2004 Taro USA gross sales of approximately \$552 million and \$580 million, and attributed approximately \$33 million and \$55 million of these respective amounts to those branded products. Ex. D-63 at 61-62. The Audit Strategies Memorandum had noted, "As branded sales increase, the Company intends to monitor accounts receivable reserves separately for branded and generic receivables." Ex. D-72 at 6. At the bottom of the page of the 2003-2004 annual and 2004 quarterly versions of the Accounts Receivable Summary exchanged between the audit team and Taro USA, there was a "Divisional Accounts Receivable" schedule, breaking down by dollar amount and percentage, accounts receivable by generic products and branded prescription products at year end 2003 and 2004 and each 2004 quarter end. Ex. D-79 at 2-3 (annual version attached to February 4 meeting agenda); Exs. D-82 at 3-5, D-84 at 2-3 (both versions attached to February 7-8 emails); R.D. 139a at 925-26 (Laccetti).

receivable are fairly stated as currently presented. We are now asking for account level detailed analysis from the Company to support [its] position." Ex. D-87 at 1. Earlier that day, the senior manager wrote to management in this regard that: (1) it "still owes us some schedules for A/R and needs to get us detailed items that we have selected as part of our A/R testing," as well as "the A/R rollforward for the period September 30 – December 31, 2004"; (2) "we need some additional analysis to be comfortable that there are adequate [accounts receivable] reserves"; and (3) this was one of two issues about which "[w]e are especially concerned" in the audit. Ex. D-86 at 1, 2.

At the February 11, 2005 closing meeting for the Taro USA audit, attended by Laccetti and the Israeli partner, company management attributed the "lack of order" in providing support for the required level of reserves to "the drop in sales in Q2." Ex. D-91 (Israeli partner's notes); Ex. D-234 at 2 (translation from Hebrew). The partner had called that sales drop to Laccetti's attention in the engagement instructions (Ex. J-26 at 3, 6), and Laccetti had also noted it in audit planning (e.g., Ex. J-29 at 7 (Internal Control and Fraud Considerations form: Taro USA's sales "have decreased dramatically in the second quarter of 2004" due to 2004 "change in the company's discount policy"))).

Regarding next steps, Taro USA was "supposed to prepare a list of supporting calculations that will be examined by Ernst & Young, and the reserves will be updated accordingly. Among the documents there will be correspondence with the customers." Ex. D-234 at 1 (Israeli partner's February 13, 2005 notes of discussions with Laccetti). Also, "there is an aging report according to which the balances were examined and, with regard to customers of over one year, explanations will be given. In addition, the sums that were collected during January will be examined." *Id.* at 1-2. As to the aging report, on February 8, 2005, Laccetti had stated he was "now asking for account level detailed analysis from the Company," and his notes of the discussion of "A/R" with Taro USA at the February 11, 2005 audit closing meeting included a reference to "Doing detailed analysis." Ex. D-87 at 1; Ex. D-88 at 3; see Ex. D-84 at 1; Ex. D-82 at 1; Ex. D-85 at 1.

On Tuesday, February 15, 2005, Laccetti was still "waiting on some open items from Taro [USA] which we are expected to receive on Thursday," which included "getting more tangible support and comfort with net accounts receivable." Ex. J-22 (senior manager's email to principal auditor). It remained for the Ernst & Young audit team to decide if the additional material "meets our expectation," to "complete our analysis," and to determine if the team was "satisfied with the results." *Id.*

The audit team later communicated to the principal auditor that "timely preparation of reserve schedules were not given to us in a timely manner, delaying the timing of our audit procedures." Ex. J-25 at 2. The team also explained that Taro USA never "prepare[d] a specific chargeback estimate" or "a detailed calculation to support the allowance for chargebacks at 12/31/04," as it ultimately did for the other allowances. Ex. L-22 at 20, 22. While the team used the calculations to "audit[] each of the other A/R reserves independently," the chargeback reserve was left to be "audited as a

component of the A/R allowances in total.” *Id.* at 20. Taro USA never supplied the planned analysis of cash collections as a percentage of gross accounts receivable, only data on cash collections as a percentage of gross sales. R.D. 135 at 372 (Laccetti).

On February 17, 2005, Laccetti still did not know “where we stand” on accounts receivable reserves. Ex. D-253. But he directed the senior manager to “[d]raft the SRM right now with the a conclusion that AR reserves ok,” pending “final AR analysis,” because “we should be in a position to issue at least a Draft of the SRM to Israel with an e-mail laying out whatever is open,” which is “the best we can do.” *Id.*

The February 18, 2005 draft Summary Review Memorandum expressed the unqualified conclusion that “the net accounts receivable is fairly stated.” Ex. J-6 at 4. But when, the next day, the principal auditor’s engagement partner asked whether, in light of “no additional reserve [having been] recorded in regard to A/R,” Laccetti was “completely satisfied with the existing level of reserves” and had “received all supporting evidence,” the Israeli partner did not believe he received “a clear yes.” Ex. D-100 at 2; R.D. 140a at 1284-85. Before answering, Laccetti had written the senior manager, observing, “AR is tough, but I think we are coming out OK,” and received the response, “With respect to A/R – I think we are as comfortable as we can get, and we summarized that in the SRM.” Ex. D-256 at 1; Ex. D-98. On February 21, 2005, Laccetti wrote to the Israeli partner, “We summarized in the SRM how we went about getting comfortable with the AR. Due to the fact that the Company can not give us lag reports related to subsequent cash receipts or accounts receivable allowances and the fact that they have no formal methodology to test, it is difficult to review appropriateness of allowance without looking at trends and specific accounts. Not considering the WAC [receivable] of \$11 million and [a] \$20 [million special reserve not in question here], based on the information we reviewed, we believe the AR is OK.” Ex. D-100 at 2.

Under the circumstances, the Israeli partner asked Laccetti to supply certain additional documentation and to participate in a conference call “to discuss again” accounts receivable reserves and another “problematic” issue. Ex. D-100 at 1; see R.D. 135 at 444 (Laccetti testified he, too, understood the accounts receivable reserves issue to be “problematic”); R.D. 139a at 936-38.¹⁷

¹⁷ The Israeli partner convened the conference call on February 23, 2005, the day before Taro USA’s parent company planned to issue a press release disclosing its 2004 financial results, and the call lasted for up to two hours. See R.D. 180 at 55-56 ¶ 179 (citations). Participating were Laccetti; the engagement partner and the audit manager on the parent company audit; and the senior and junior foreign filing reviewers (respectively, a principal at Ernst & Young, who also advised on accounting- and SEC-related matters as a member of the firm’s Capital Markets Group and served as independent reviewer on the 2004 Taro USA audit, and a senior manager at the principal auditor), who were responsible for reviewing Taro’s Form 20-F filing for

D. In Response to the Audit Difficulties, Laccetti Assessed the Reasonableness of the Chargebacks Allowance Not Individually, Like the Others, But as Part of Total Accounts Receivable Allowances.

Laccetti participated in preparing and reviewed work papers, including summary memoranda, that purported to record the Ernst & Young audit team's work on Taro USA's revenue recognition, accounts receivable, and accounts receivable allowances for 2004. Two of the memoranda—one on accounts receivable allowances and one on revenue recognition—were completed by February 24-25, 2005, when Laccetti released them to the principal auditor. Ex. J-07; Ex. D-109; Ex. D-112; Ex. D-113. A third—on accounts receivable—overlapped somewhat with the first, and supplied the entire discussion of "Accounts Receivables and Net Sales" in the Summary Review Memorandum released to the principal auditor in draft on February 18 and in final on April 11, 2005. Ex. J-6; Ex. J-9. That last memorandum also included a short succeeding section on "Allowances and Accrued Liabilities." According to the engagement instructions and to forms Laccetti signed, this document's role included providing a "brief discussion of each important accounting and auditing issue," "describ[ing] the results of [the] audit procedures," and "summariz[ing] important audit results and conclusions." Ex. J-26 at 15, 22; Ex. D-126; see R.D. 135 at 235-38.

The Revenue Recognition Memorandum stated the following understanding of Taro USA's estimation of sales adjustments and related reserves: Taro USA created "[p]rovisions for sales discounts, and estimates for chargebacks, rebates, damaged product returns, and exchanges for expired products" as a "reduction of product sales revenues at the time such revenues are recognized," which are management's "best

compliance with US GAAP and SEC requirements, in accordance with *American Institute of Certified Public Accountants, SEC Practice Section Manual, Member Firms with Foreign Associated Firms that Audit SEC Registrants*, Appendix K, Section 1000.45 (as incorporated in PCAOB interim quality control standards through Board Rule 3400T(b)). E.g., R.D. 137 at 556, 675-76, R.D. 139a at 968, 979-80 (Laccetti); *id.* at 1031 (Israeli partner); R.D. 140a at 1188 (audit manager). No documentation of the discussion has been offered, and, when questioned in connection with this case, no participant could remember much, if anything, about the substance of the discussion. E.g., R.D. 135 at 444-45 (Laccetti); R.D. 140a at 1253, R.D. 142 at 1826-27 (Israeli partner); R.D. 140a at 1189-90 (audit manager: on "the subject of accounts receivable," the conversation "principally concerned" the \$20 million special reserve), 1216-17, 1222-23; Ex. L-183 at 3, 4, 21 (junior reviewer's investigative testimony, also referencing special reserve). The Israeli partner and audit manager testified that by the call's end they believed they had the comfort needed to give "negative assurance" to the parent company, and, after the call, both foreign filing reviewers told the Israeli partner they, too, were not presently aware of any matters that would impact the press release. R.D. 140a at 1189-90; R.D. 141 at 1668-69, 1681-83; R.D. 142 at 1828. It issued on February 24. Ex. D-261.

estimate at the time of sale based on historical experience adjusted to reflect known changes in the factors that impact such reserves.” Ex. D-63 at 5. The audit team reported that it had “completed all planned work steps related to revenue,” including specified analytical procedures, two referencing sales allowances: “[c]ompare the amounts of allowance issued with those of prior periods” and “[c]ompare the current period’s sales allowances as percentages of sales by product line.” *Id.* at 6. There is no support that the second was done. See R.D. 137 at 523-26 (Laccetti). The team also stated it had performed “a detailed transaction test [of] the controls on the revenue recognition process” and “analytical procedures relate[d] to gross and net sales,” but the controls testing did not encompass items that reduced gross to net revenue, and the referenced analytical procedures did not relate to net sales. *Id.*; Ex. D-63 at 5, 55-75.

The Accounts Receivable Allowances Memorandum described about a dozen separate accounts, one of which was chargebacks, provided the 2003 and 2004 year-end balance of each account, and discussed audit work on the accounts individually and in the aggregate. Ex. L-22 at 17-22. Under “Allowances and Accrued Liabilities,” the Summary Review Memorandum specified that “[w]e performed procedures to test the reasonableness of [Taro USA’s] estimates” for these accounts, including “accrued chargebacks,” at December 31, 2004. Ex. D-125 at 3. The procedures reportedly “consisted of reviewing significant contractual terms, historical payments on Medicaid rebates, credit memo patterns, documenting [the company’s] methodologies and performing analytical review procedures on [its] accruals.” *Id.* at 4. Laccetti testified that the only such work that was done specifically on chargebacks was to compare the chargebacks reserve balance at the end of 2003 and 2004 and investigate unexpected changes or the absence of expected changes. R.D. 135 at 435-37; see D-46 at 46.

The audit team did not perform the other planned work steps for chargebacks. R.D. 135 at 366-71 (Laccetti). Rather, under those work steps, reference is simply made to the Accounts Receivable Allowances Memorandum, which stated that “the chargeback reserve was audited as a component of the AVR allowances in total.” Ex. L-22 at 20. The accounts receivable work papers contained information and analysis for certain specific sales allowance items issued in 2004, but not for chargebacks. See Ex. L-24; R.D. 139a at 1007-09 (Laccetti). The most Laccetti could say about chargebacks data was “the submission of chargebacks is in [those] workpapers, at least in the total,” apparently referring to the chargebacks line item in a schedule listing types of 2004 sales allowances next to a combined total of amounts issued in 2004 and reserved for at year end 2004 for each (Ex. L-22 at 14). R.D. 137 at 559-61; R.D. 139a at 1006-07. We interpret the statement in the initial decision that the audit team “confirmed the amounts that Taro USA had paid or credited for each sales adjustment during 2004” (I.D. 62), for which no record support is cited or apparent, as making the same reference as Laccetti, analogous to a point made in the prior paragraph of the decision about the sales allowance reserves, that a similarly summary work paper “show[s] that the [audit] team matched Taro USA’s total reserves to the sum of the reserves for the individual sales adjustments” (I.D. 61).

Likewise, regarding the period subsequent to year end 2004 but before the end of the audit field work, no reference was made to a review of chargebacks, in particular. And, as to other sales allowances issued by Taro USA during that period, the work papers indicate that the audit team, without explanation, raised the planned threshold for testing, repeatedly asserting that 25% of tolerable error is \$150,000 (Ex. D-46 at 44, 45, 47; Ex. L-110 at 46, 50; R.D. 135 at 367-68), when, in fact, 25% of \$360,000 is \$90,000. Specifically, the work papers state that the team: (1) reviewed discounts and cash returns and "noted one return greater than \$150,000," which "related to 2003, and we concluded that it was properly reserved for at year end"; (2) noted "per discussion with [Taro USA] and through G/L [general ledger] inquiry; that there were no billback promotions issued in the form of a credit memo that were greater than \$150,000"; (3) noted that there were no "rebate payments greater than \$150,000"; (4) noted "per discussion with [Taro USA] that there have been no credits issued subsequent to year end for any indirect rebates/admin. fees"; and (5) "obtained the sales journal from 1/1/05 until 2/17/05 and reviewed for credits greater than 25% of TE [tolerable error]," and then "selected the 3 largest and agreed them" to the rebate log, "noting all accruals were great[er] than the amount per the sales journal." Ex. D-46 at 44, 45, 48, 49; Ex. L-110 at 46, 50-51, 52. At the hearing, Laccetti could not recall considering any specific chargebacks processed or recorded in connection with any subsequent events procedures. R.D. 137 at 547-50; see Ex. D-303 at 63-65 (senior manager on audit testified in investigation that no subsequent events review of chargebacks was done).

The Accounts Receivable Allowances Memorandum analyzed chargebacks as follows. It noted that Taro USA "did not prepare a detailed calculation to support the allowance for chargebacks at 12/31/04." Ex. D-54 at 4. Laccetti testified that Taro USA did not do so because "they looked at the chargeback allowance by just looking up the processed chargebacks, and it was difficult to identify sales and chargebacks; so they had difficulties in compiling the calculation." R.D. 139a at 1013-14. The balance of the memorandum's chargebacks analysis proceeded in this way:

The chargeback reserve decreased by \$16.27 million from prior year, while over the same period, gross trade accounts receivable increased by \$11.9 million. The decrease was due to the excess chargebacks given to wholesalers in 2003 in which over \$10 million was subsequently collected in 2004. Based on our procedures performed, the amount accrued at December 31, 2004 appears reasonable. As EY audited each of the other AR reserves independently, the chargeback reserve was audited as a component of the AR allowances in total. See Summary section below.

Ex. L-22 at 20, cited by *id.* at 3 (Accounts Receivable Leadsheet, 12/31/04 Audit: "Chargebacks were considered in the audit of A/R reserves as a whole.").

The "Summary" section, at the end of that memorandum, explained, "In order to test the adequacy of these reserves in total, [we] calculated [DSR] for 2004 and compared it to 2003." *Id.* at 22, citing *id.* at 8 (work paper version of Accounts Receivable Summary schedule discussed with Taro USA on February 4, 2005). What the audit team found was that "DSR increased from 111 days in 200[3] to 171 days in 2004." But "when we excluded over \$10 million in aged AR that related to [Taro USA's] three largest customers (who dictate payment terms due to the volume of sales they provide to [the company]) the Days in A/R were calculated at 150 days, which was in line with 2002 and 2001 DSR." *Id.* at 22. The team concluded, "Although management did not prepare a specific chargeback estimate, based on our procedures performed above on the detailed calculations and the overall realization of accounts receivable, the allowances at December 31, 2004 appear reasonable." *Id.*; accord R.D. 139a at 953, 1014-15 (Laccetti); Ex. L-181 at 39, 53-54 (investigative testimony of senior manager).

The work papers do not reflect any similar adjustment for the other years to make the DSRs comparable. See, e.g., R.D. 144 at 2633-35 (Laccetti's expert). At the hearing, Laccetti could not recall considering whether such adjustments should be made (R.D. 135 at 466-68, R.D. 137 at 494-95), even though the work papers attributed most of the \$10 million excluded to customers who "have historically dictated payment terms, causing [Taro USA's] days in receivable to be high" and noted that it has "a history of collecting such items" (Ex. L-22 at 5, 6). Furthermore, in making the multi-year comparison of DSRs, the audit team used substantially incorrect DSRs for 2002 and 2001, which minimized the dramatic increase: 140.26, instead of 93.14, for 2002 and 148.13, instead of 97.84, for 2001. Compare Ex. L-22 at 8 with Ex. L-24 at 172 (work paper from 2004 Taro USA audit showing DSR of 93 for 2002); Ex. D-9 (work paper from 2003 audit showing correct DSRs for 2002, 2001); Ex. D-79 at 2, 12 (data for discussion at February 4, 2005 meeting with Taro USA reflected that numbers used as net sales to calculate 2002 and 2001 DSRs were actually net sales for 2001 and 2000); Ex. D-303 at 100-03 (senior manager's investigative testimony); see R.D. 135 at 469-73, R.D. 137 at 488-89 (Laccetti).

In addition to the DSR analysis, the Accounts Receivable Allowances Memorandum noted that the "total allowance for A/R reserves increased by \$20.7 million from 12/31/03 to 12/31/04," an increase from 27% to 35% of gross receivables, while gross receivables rose by \$23 million. Ex. L-22 at 21. It explained that "[o]ne of the main causes of the increase in the A/R reserves" in total was the \$20 million special reserve. *Id.* at 22. The work papers listed these figures and showed that total reserves as a percentage of gross receivables fell to 26% in 2004 when the \$11 million excess chargeback receivable and \$20 million special reserve were omitted. *Id.* at 2-3, 8.

The Accounts Receivable Memorandum began by noting, similarly, that, adjusting for the \$11 million "WAC receivable" relating to the excess chargebacks and the \$20 million special reserve, not in question here, gross receivables grew by \$13 million from year end 2003 to year end 2004, to \$166 million, whereas accounts

receivable reserves rose by \$1 million to \$42 million. Ex. L-22 at 5. A tick mark on the 2004 Accounts Receivable Leadsheet asserted, "This was due to a combination of drop in sales for 2004 (specifically the 2nd quarter), which reduced allowances booked and a slow down in payments [fro]m the three largest wholesalers in 2004." *Id.* at 3. Another tick mark explained that "[r]ecovery" of "sales in the 3rd and 4th quarters," "along with higher gross sales for 2004 increased the gross receivables" in 2004. *Id.*; see *id.* at 5 (memorandum references "the big decrease in sales in the second quarter of 2004," in which the wholesalers "reduced their orders to work off their existing inventories" and observed that "[s]ales in the third and fourth quarter returned to normal levels"), 1638.

Then the Accounts Receivable Memorandum provided further detail about "our analytical review of the Days in Receivable." Ex. L-22 at 5. It made clear that the calculation excluded the \$11 million "WAC receivable" and the \$20 million special reserve. And the memorandum explained that the 2004 DSR calculation had been further adjusted by subtracting the "\$10 million of the outstanding A/R in over 90 days" because, "[u]pon further investigation we determined that [it] relates to items that are either advance chargebacks or duplicate rebates taken by customers that take more time and effort to collect" but that Taro USA "has a history of collecting." *Id.* The memorandum repeated the flawed comparisons of multi-year DSRs: "the days in A/R drop down [after removal of the \$10 million] to approximately 150 days and appear to be in line with the historical days percentage going back to 2002 and 2001." *Id.* at 5-6.

Next, the Accounts Receivable Memorandum listed five items "we evaluated" to "gain some more comfort with the accounts receivable balance." The evaluations consisted of: (1) determining, "in looking at the overall net receivable," that "most of the aged items were in the 0-60 days category"; (2) rendering the excluded \$10 million as a percentage of gross and net receivables (6%, 8%) and noting that most of it was owed by three large wholesalers who "account for a significant percentage of [Taro USA's] sales and have historically dictated payment terms, causing [its] days in receivable to be high"; (3) describing the confirmations testing done in the audit, in which "[o]nly \$2,000 of the selection [of receivables totaling \$73 million] could not be verified," and stating, "This gave us additional comfort that the client is able to collect on outstanding receivables."; (4) computing a "three year trended days in receivable" that "was averaged at 133 days compared to the 150 days above" and attributing "[p]art of this" to the company being "shorthanded due to cut backs"; and (5) noting that management had "indicated that they were communicating with the three large wholesalers" on the "\$11 million in WAC receivable relating to excess chargebacks" and "that if they are unable to receive direct payment from the wholesalers that they will reduce chargebacks or discounts given to wholesalers to eventually satisfy the receivable balance," which was deemed reasonable since "incorrect excess chargebacks were given to the wholesalers in the first place" and "a negotiation of reduced chargebacks is a good possibility," as "chargebacks are a normal part of [Taro USA's] business process." *Id.* at 6. The Memorandum also stated that "correspondence has been sent to the wholesalers to recover these [excess chargebacks] amounts" and that Taro USA

"has informed us that [it is] in the process of negotiating new" general service agreements with them and "expect[s] to receive this money in 2005." *Id.* at 5.

Furthermore, the final version of the Summary Review Memorandum stated generally that, as a result of the deficiency in Taro USA's accounts receivable reserves process, "we expanded our procedures to perform detailed substantive tests of individual accounts receivable to gain comfort that the amounts were properly recorded at net realizable value." Ex. D-125 at 4. The "detailed" tests were represented by six tick marks on nine receivables, totaling \$12,158,275, on a work paper reproducing Taro USA's year-end 2004 aging report, which, overall, contained 36,875 line items of receivables, consisting of \$184,720,173 in open invoices and \$92,076,801 in open deductions (or open debits), offset by \$96,462,030 in open credits and \$13,883,223 in open payments. Ex. L-23 at 2, 210, 873, 1068, 1140, 1146, 1152, 1185, 1203, 1215, 2129; Ex. L-174; R.D. 135 at 415-17, R.D. 137 at 535-36.

Although not discussed in the memoranda summarizing the 2004 audit work performed, certain additional analytical procedures relating to total accounts receivable reserves were documented. They appear in a work paper version of the Accounts Receivable Summary for 2001 to 2004 that had been prepared for the February 4, 2005 meeting with Taro USA; a work paper version of the February 7, 2005 Accounts Receivable Summary for each quarter of 2004; a work paper version of February 7, 2005 Gross/Net Sales and Cash Analysis, containing the "lag analysis"; and a work paper reproducing the Cash Collections sheet prepared for the February 4, 2005 meeting and adding to it net sales and gross sales figures for 2003 and 2004 and a calculation of "% of net sales to gross sales" for 2003 and 2004. Ex. L-22 at 8-12, 15, 1640; R.D. 139a at 925-27, 1003-05; see R.D. 180a at 106, 110-11, 134.

E. Ernst & Young, Through Laccetti, Reported to the Principal Auditor on the 2004 Taro USA Audit, Which that Auditor Used in Issuing an Unqualified Opinion on the Parent Company's Financial Statements.

Ernst & Young reported on its 2004 Taro USA audit and expressed an opinion about Taro USA's 2004 financial data in certain submissions to the principal auditor, signed by Laccetti, for use in the audit of the parent company's 2004 consolidated financial statements. In particular, he signed and released to the principal auditor two forms used to document the results of a subsidiary audit performed at the request of another firm for inclusion in the parent company's consolidated financial statements.

The first, a Review and Approval Summary for Audit Engagements, gave a "Report Release Date" of "3/8/05." Ex. J-8 at 1; R.D. 137 at 537-38 (Laccetti). It also included representations, signed and dated April 18, 2005 by Laccetti and the senior manager on the 2004 Taro USA audit, that: the Taro USA audit team had "performed sufficient review procedures in high-risk and other sensitive audit areas to be satisfied that the detailed review was adequate and that appropriate audit recognition was given

to all important financial statement amounts and disclosures"; "The audit has been planned appropriately"; "The scope of our audit is sufficient to support our report"; "The audit work has been performed in accordance with the standards of our firm and the profession"; "The significant judgments made and conclusions reached throughout the audit process were appropriate"; "All significant accounting, auditing, and reporting matters are described in the SRM or its attachments" and team members "concur with the conclusions regarding them"; and "The audit procedures achieved their purposes and the conclusions reached are consistent with the work performed." Ex. J-8 at 3-4.

The second form, a Full Scope Conclusion, signed and dated April 18, 2005 by Laccetti, stated that it "should be read in conjunction with the Summary Review Memorandum dated February 18, 2005, which describes the results of our audit procedures." Ex. D-126 at 1, 2.; R.D. 137 at 538-39 (Laccetti). This form represented that the Ernst & Young audit team performed a full scope engagement on Taro USA's 2004 reporting package, including "examining, on a test basis, evidence supporting the amounts in the" reporting package, in accordance with the principal auditor's engagement instructions, that the team "planned and performed our audit procedures to obtain reasonable assurance about whether" the reporting package was "free of material misstatement based on the tolerable error assigned by" the principal auditor, and that no unadjusted audit differences would "warrant us to revise our opinion" or "materially misstate the reporting package." Ex. D-126-at 1, 2-3.

The Summary Review Memorandum, sent to the principal auditor in draft on February 18, 2005 and in final on April 21, 2005, stated the Ernst & Young audit team's conclusion that Taro USA's "net accounts receivable is fairly stated" and, more generally, its "opinion that the scope of our audit was adequate and that the financial data of [Taro USA] for the year ended December 31, 2004 are presented fairly, in all material respects, in conformity with [GAAP], applied on a consistent basis." Ex. D-125 at 3, 11. Attached to that Memorandum was a Summary of Audit Differences, which, in final, included no adjustments relating to accounts receivable allowances. Ex. J-9 at 13.

Additionally, the Accounts Receivable Allowances Memorandum for 2004, which Laccetti approved and released to the principal auditor on February 24, 2005, concluded that, "based on our procedures performed above on the detailed calculations and the overall realization of accounts receivable, the [accounts receivable] allowances at December 31, 2004 appear reasonable." Ex. D-54 at 6. And the Revenue Recognition Memo, substantially prepared by Laccetti and sent to the principal auditor on February 25, 2005, represented that "[w]e have completed all planned work steps related to revenue"; that, "[b]ased on the related combined risk assessments and the results of the procedures in this and related areas, we believe that the procedures completed are appropriate" for "financial statement assertions [regarding revenue] and their respective combined risk assessments"; and that, "[a]s a result of completing the planned procedures, no audit differences were identified." Ex. D-63 at 5, 6.

Using Ernst & Young's audit of Taro USA and the other audit work on the parent company's 2004 consolidated financial statements, the principal auditor expressed an unqualified opinion on those financial statements. The Israeli firm's audit report, dated February 23, 2005, did not refer to the audit work done by any other firm. The report was included in the parent company's Form 20-F filed with the SEC on June 30, 2005.

F. The Parent Company Subsequently Restated Its Financial Results Due Principally to Taro USA's Erroneously Low Estimates of Chargebacks.

In 2007, Taro USA's parent company filed restated financial statements for 2004 and other periods. See Ex. D-219 at 4. Laccetti explained that the restatement related principally to chargeback estimates and did not involve "sales returns and price adjustments, other than chargebacks." *Id.* at 2; R.D. 137 at 633. An Ernst & Young memorandum, dated June 14, 2006 and co-signed by him, stated that, "[i]n connection with the audit of the 2005 reporting package for Taro USA and based on SEC Comment Letters [to the parent company] in late 2004 and 2005 requesting certain information regarding sales returns and price adjustments including a response from their external auditors," Ernst & Young "performed additional procedures in this area." Ex. D-219 at 2. The procedures and "additional information received from [Taro USA's] primary wholesale customers" led management and the auditors to conclude that Taro USA "did not adequately reserve for chargebacks from wholesalers" and that the parent company's consolidated financial statements for 2003 and 2004 needed to be restated. *Id.* at 2, 3. The memorandum observed, "A crucial element in estimating future price adjustments from wholesalers involves receiving or estimating the amount of [the company's] inventory maintained by the wholesalers that is subject to the risk of chargeback. Prior to 2006, Taro USA did not have specific terms in [its] contracts with the wholesalers requesting this information from the wholesalers on a periodic basis." *Id.* at 2. Lacking "this inventory at wholesaler information," Taro USA "developed internal methods of estimating [its] chargeback adjustments in prior years which were mostly analytical analysis of historical data." The restatement "reduced net revenue and the related receivables." *Id.* at 3. Taro USA's chargebacks reserve as of December 31, 2004 was adjusted from \$2.37 million to \$95.4 million, on a cumulative basis back to December 31, 2002, with a cumulative balance sheet effect as of year-end 2004 of \$93 million and an income statement effect for 2004 of \$9.8 million. Ex. D-215.

IV.

As noted, Laccetti was the auditor with final responsibility at Ernst & Young for the audit of Taro USA's financial information for the year ending December 31, 2004. The principal auditor, without reference in its audit report, used the Taro USA audit in issuing an unqualified opinion on the consolidated financial statements of Taro USA's parent company for that period. *E.g.*, R.D. 140a at 1183-86, 1286-89; see, *e.g.*, AU §§ 543.03-.04, .10-.13. In that connection, Laccetti made various representations to the principal auditor about the work and conclusions of the 2004 Taro USA audit, including

that, based on performance of an audit in accordance with PCAOB auditing standards, Taro USA's 2004 "net accounts receivable is fairly stated" and its 2004 financial data "are presented fairly, in all material respects, in conformity with" GAAP. *E.g.*, Exs. D-128 at 1, J-6 at 4, 11, J-8 at 3-4; R.D. 139a at 985-88; *see, e.g.*, Ex. J-26 at 20-24 (engagement instructions); AU §§ 543.12 (providing, among other things, that, "prior to the report release date," principal auditor "must obtain, and review and retain," certain documents and information from other independent auditor to whom reference not made). As AU § 543.03 makes clear, "[r]egardless of the principal auditor's decision" about whether to make reference in its report to the other auditor, "the other auditor remains responsible for the performance of his own work and for his own report."

The charges before us against Laccetti all concern audit work he acknowledges performing or reviewing on Taro USA's 2004 "sales adjustments and related reserves in total, and for chargebacks specifically." *E.g.*, OIP ¶¶ 34, 43, 49. As to this work, the OIP alleges that he violated PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, and Rule 3200T, *Interim Auditing Standards*, by:

- failing to exercise due professional care and skepticism, in violation of AU § 150, *Generally Accepted Auditing Standards*, and AU § 230, *Due Professional Care in the Performance of Work*;
- failing to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion, in violation of AU § 150 and AU § 326, *Evidential Matter*;
- failing to assess adequately the reasonableness of certain material accounting estimates, in violation of AU § 342, *Auditing Accounting Estimates*;
- failing to perform a retrospective review of estimated sales adjustments, including chargebacks, reflected in the financial data of the prior year to determine, in light of subsequent experience, whether management judgments and assumptions relating to those estimates indicate a possible bias and thereby obtain additional information about possible management bias in making the 2004 estimates, in violation of AU § 316.64, *Considerations of Fraud in a Financial Statement Audit*;
- failing to comply with AU § 329, *Analytical Procedures*;
- failing to investigate appropriately management representations contradicted by other audit evidence, in violation of AU § 333, *Management Representations*;

- failing to evaluate appropriately credit claims processed after year end, contrary to AU § 560, *Subsequent Events*; and
- failing to take appropriate steps to assess information learned after expressing an unqualified opinion, in violation of AU § 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. E.g., OIP ¶¶ 34-38, 45, 47, 69-71.

The initial decision found that the Division proved by a preponderance of the evidence that “the [audit] testing of Taro USA’s total reserves was deficient,” “insofar as that total reflected the chargeback reserve.” I.D. 62, 71. The decision held that PCAOB auditing standards required an individual assessment of the chargebacks reserve and determined that under either that approach or the approach that Laccetti argued he had followed of auditing the chargebacks reserve as a component of total accounts receivable reserves, Laccetti failed to exercise due professional care and skepticism, failed to obtain and properly evaluate sufficient competent evidential matter, and failed to properly audit a significant accounting estimate, in violation of AU §§ 150, 230, 326, and 342. I.D. 60-74. As to Laccetti’s assessment of Taro USA’s ability to reasonably estimate, in accordance with GAAP, its individual sales adjustments and related reserves other than chargebacks, and his assessment of the reasonableness of those other estimates, the decision found that no violation had been proven. I.D. 61-62. Next, the decision rejected affirmative defenses asserted by Laccetti. I.D. 86-90. Determining that Laccetti’s “deficient assessment of Taro USA’s chargebacks reserve individually and as incorporated in Taro USA’s total reserves” was reckless, the decision ordered that he be suspended from associating with any registered public accounting firm for six months and that he pay a \$25,000 civil money penalty. I.D. 109-115.

Laccetti petitions for Board review of these findings of violations and of the sanctions imposed. His petition includes challenges to the hearing officer’s admission, over objection, of the Division’s expert witness’s report and testimony, and the hearing officer’s rejection of Laccetti’s affirmative defenses. The Division petitions for review of the hearing officer’s exclusion of certain post-audit evidence it argues is relevant to liability and sanctions. To the extent the initial decision found the Division had not proven violations regarding sales adjustments and related reserves as a whole, it seeks review of that determination. The Division also seeks review of the sanctions imposed.

Additionally, the initial decision found that a retrospective review of Taro USA’s accounts receivable allowances had not been performed, in violation of AU § 316.64. I.D. 75-77. The hearing officer stated that Laccetti had been negligent in that regard and imposed no additional sanctions for that violation. I.D. 113 n. 50. Laccetti did not petition for Board review of any determinations made on the AU § 316.64 charge. The Division challenges the finding of no more than negligence and the lack of a sanction.

Finally, the decision dismissed the AU §§ 329, 333, 560, and 561 charges against Laccetti as “not proven,” although it dismissed the § 329, 333, and 560 charges based largely or entirely on the view that they were “fully and more appropriately addressed” or “better considered” under the charges as to which violations were found or that AU § 560 did not apply by its terms to this case. I.D. 77-86. The Division seeks review of the dismissal of the charges brought under all four of these standards.

In summary, the Division argues, in support of its petition for review or in opposition to Laccetti’s petition, that Laccetti recklessly failed to properly perform audit procedures, to adequately evaluate audit evidence, and to obtain sufficient evidence to gain reasonable assurance that Taro USA’s 2004 financial reporting package was free of material misstatement, whether caused by error or fraud. More specifically, the Division contends that Laccetti violated AU §§ 150, 230, and 326 by inadequately evaluating audit evidence, and obtaining insufficient audit evidence, about Taro USA’s 2004 recorded sales adjustments (or sales allowances) and related reserves (or accounts receivable allowances) in total and for chargebacks specifically. According to the Division, Laccetti needed the evidence both (1) to assess Taro USA’s adherence to GAAP, in light of the company’s recognition of revenue at the time of sale and consequent estimation of the amount of sales allowances it would incur based on those sales; and (2) to form conclusions about the validity of high-risk assertions of material significance relating to the \$248 million in net sales (reflecting total year-end 2004 sales adjustments of \$330 million, \$200 million in chargebacks) and \$114 million in net accounts receivable (reflecting year-end 2004 reserves of \$42 million) presented in Taro USA’s 2004 financial reporting package. Moreover, viewing the sales adjustments and related reserves as significant accounting estimates, the Division argues that Laccetti failed to satisfy specific requirements under AU § 342 for obtaining and evaluating sufficient audit evidence to support the reasonableness of such estimates.

Furthermore, the Division argues that Laccetti failed to comply with additional PCAOB standards governing performance of certain types of procedures, or consideration of certain types of information, relating to the sales adjustments and related reserves. According to the Division, Laccetti, operating in an environment of scant information about a large and important part of Taro USA’s sales allowances and relying mainly on high-level analytical procedures:

- accepted a management representation about the 87% decrease in the year-end chargebacks reserve from 2003 to 2004 that did not make sense and conflicted with other audit evidence, contrary to AU § 333;
- employed a faulty analysis of the average number of days for payment to be made on sales—DSR—as the primary analytical procedure to test the adequacy of Taro USA’s 2004 year-end accounts receivable reserves as a whole, contrary to AU § 329;

- failed to analyze the 2004 year-end reserves in total and for chargebacks by reference to certain year-end data in the work papers indicating that the reserves were materially understated, again contrary to AU § 329, such as:
 - comparing calculations appearing in the work papers of total reserves as a percentage of gross receivables (26%) to total sales adjustments as a percentage of gross sales (57%) and total gross sales, less cash collections, as a percentage of gross sales (60%); and
 - comparing the chargebacks reserve, which was less than 5% of gross accounts receivable, to a planned calculation of 2004 sales adjustments for chargebacks (processed claims and year-end outstanding estimated claims) as a percentage of gross sales (35%);
- did not consider, as had been planned, information obtained about sales allowance claims processed by Taro USA after the balance sheet date, viewed as transactions that provide additional evidence of conditions existing at that date, that affect the estimates of the reserves, and that require consideration under AU § 560; and
- failed, under AU §§ 333 and 561, to investigate, and to consider the effect on the audit of, representations by the parent company to SEC staff after the field work had ended that allegedly contradicted its earlier representations to the staff about inability to monitor and estimate inventory at wholesalers, relevant to estimating sales allowances.

In addition, the Division argues that Laccetti recklessly violated AU § 316.64 because a retrospective review of Taro USA's 2004 sales allowance estimates was not performed, despite Laccetti's knowledge that it was required, inclusion of the procedure in the audit plan, and representation to the principal auditor that it had been performed.

Overall, the Division seeks review of the sanctions imposed. It urges that Laccetti be barred from associating with registered public accounting firms, with leave to petition to associate in three years, and ordered to pay a \$100,000 civil money penalty.

Laccetti, in support of his petition for review or in opposition to the Division's petition, contends that PCAOB auditing standards did not require him to specifically assess chargebacks. He argues that, through a combination of audit work on the other individual accounts receivable reserves and on the total reserves balance, he evaluated Taro USA's ability to estimate, and the reasonableness of its estimate of, accounts receivable reserves as a whole, in compliance with the standards. He also argues that the substantive analytical procedures forming part of his audit work on the reserves complied with AU § 329 and that it left the choice of such procedures to his professional judgment; that AU § 560 did not require him to review sales allowance claims processed

after the balance sheet date; and that nothing came to his attention that required him to take action under AU § 561, if it applies here. Furthermore, he presses his affirmative defenses, claiming that a particular expert should have been allowed to attend his investigative testimony and that this proceeding is invalid under separation of powers principles and the taxation power of the United States Constitution. On sanctions, he contends his violation of AU § 316.64 was no more than negligent and merits no sanction. Overall, he claims that when "mitigating and contextual circumstances" are properly taken into account, anything more than "*de minimis*" sanctions are excessive.

V.

The Division bears the burden of proving the charges against Laccetti by a preponderance of the evidence. PCAOB Rule 5204(a). We apply the auditing standards as they existed at the time of the alleged violations.

There is no dispute that sales adjustments and related reserves were high-risk areas and warranted special attention in the 2004 Taro USA audit. *E.g.*, R.D. 135 at 273-74, 444 (Laccetti); R.D. 139a at 936-37 (Laccetti: "[a]ccount receivables [was] one of the highest areas" in terms of time spent in the 2004 Taro USA audit, consuming about a third of the post-planning hours, with another third devoted "to the other significant estimates and then [the rest] on the lower risk accounts"). In recognizing revenue at the time of sale, Taro USA undertook to comply with GAAP by making and recording what it deemed to be reasonable estimates of its sales allowances so as to reflect the actual amount it would collect on the sales. *E.g.*, R.D. 180 at 10 (Laccetti brief citing SAB 104). An auditor's opinion that financial data is presented in conformity with GAAP must be based on an audit conducted in accordance with PCAOB standards, and those standards require an auditor to perform audit procedures sufficient to evaluate the issuer's compliance with GAAP. *E.g.*, AU §§ 150, 326.25. Furthermore, Laccetti recognizes that, for audit purposes (*see, e.g.*, AU §§ 326.07, .13, .25, 342), Taro USA's accounts receivable allowances in total was a significant account and a significant accounting estimate whose measurement or valuation was an assertion of material significance to the financial data Taro USA reported to its parent company for inclusion in publicly reported consolidated financial statements. *E.g.*, R.D. 204 at 4.

By year end 2004, the sales allowance claims that Taro USA had processed during the year and the amount of claims it estimated were still outstanding from past sales had a combined effect of more than \$330 million on the revenue it recognized from its \$580 million in gross sales. *Ex. L-22* at 8, 12, 14-15. In estimating, at year end 2004, the value it would realize on its \$165.5 million in outstanding unpaid prior sales, net of future sales allowance claims arising from those sales, Taro USA relied on its \$42.2 million accounts receivable reserves. As Laccetti knew, Taro USA's parent company made most of its reported revenue through Taro USA, the net amount the parent company reported it would realize on its outstanding receivables derived mainly from Taro USA's sales, and a high percentage of the sales adjustments and related

reserves that affected those figures were attributable to Taro USA. Ex. J-1 at 34; Ex. D-278 at 3; Ex. D-294 at 1, 4; R.D. 135 at 197 (Laccetti). And Laccetti knew the principal auditor was using the work and report of the 2004 Taro USA engagement team led by Laccetti in auditing the parent company's consolidated financial statements.

Laccetti's understanding of Taro USA's process of estimating its total sales allowances and conclusion that the process itself was deficient had implications for the audit work that needed to be done with respect to the accounts receivable reserves. Yet that audit work was too general, limited, or flawed to support the estimate. Laccetti violated numerous PCAOB standards.^{8/}

A. Laccetti's Understanding of Taro USA's Estimation Process for Accounts Receivable Allowances

Before addressing the audit procedures that Laccetti performed or reviewed relating to Taro USA's accounts receivable allowances, we first discuss Laccetti's understanding of, and determinations about, Taro USA's process of estimating those allowances, which informed the overall audit work that needed to be done in the area. See, e.g., AU 342.10.

In planning the 2004 audit, Laccetti regarded each individual accounts receivable allowance as having its own "Calculation Process" of some sort, to be understood and tested, and stated that he planned to "[r]eview the overall reserve calculation as of December 31 and the related accounts." Ex. L-1 at 3, 5; Ex. D-15 at 3-4; Ex. D-72 at 6. The audit bore out differences in the way allowances were estimated. Ex. L-22 at 17-21. According to Laccetti's briefing in this case, Taro USA "develop[ed] an estimate of the accounts receivable allowances as a whole based on [its] management's historical experience, trends, and subjective judgments"; then Taro USA used that estimate,

^{8/} The parties dispute whether PCAOB auditing standards required Laccetti "to audit [Taro USA's 2004] chargebacks specifically" or "individually," in addition to assessing its 2004 sales adjustments and related accounts receivable allowances "as a whole," in "total," or "overall." E.g., R.D. 205 at 15-18, 48-50; R.D. 215 at 5-6; R.D. 204 at 4-8; R.D. 210 at 18-21. The OIP charged violations of PCAOB standards in both respects, the Division urged both positions, and the initial decision addressed both. See I.D. 40, 62, 71, 73, 111, 112. Laccetti does not claim that he was free to ignore the part of total accounts receivable allowances represented by chargebacks but instead that the standards allowed him to assess that part through the composite estimate of the accounts receivable allowances as a whole. See, e.g., R.D. 210 at 20-21. We need not decide whether the disputed audit approach was required. The answer does not change the fundamentals of the case, such as the characteristics of Taro USA's sales adjustments and related reserves, including chargebacks, and the surrounding circumstances in which the audit work was performed, nor does it change the outcome.

along with estimates for “most of the components of accounts receivable allowances” that it based on “performing detailed calculations” for those components, to “derive[] the estimate for the chargeback component, for which [it] did not have a detailed calculation.” R.D. 180 at 38; *accord id.* at 78; R.D. 180a at 77.

Taro USA’s estimation of the individual allowances for which it made detailed calculations was thus insufficient, by Laccetti’s own account, to estimate accounts receivable allowances as a whole or chargebacks. Management’s inability to explain in any detail the estimation process, or to “prepare a detailed calculation” or “specific” estimate (Ex. L-22 at 20, 22; R.D. 135 at 334-35, 339; R.D. 139a at 908-10, 1013-14), for the allowances as a whole or chargebacks set those apart from the individual allowances for which this was done. Laccetti testified that “each one” of the latter “had different nuances, the calculation, as well as how [the company] went through the process.” *Id.* at 916-17. That illustrates how little an understanding consisting of mere generalizations of the aspects of Taro USA’s estimation methodology distinct from those individual allowances and applicable to accounts receivable allowances as a whole and chargebacks would contribute to supporting the whole or chargebacks.

Chargebacks was hardly a trivial or indistinct allowance. Ernst & Young training on pharmaceutical industry pricing, discounts, and rebates, attended by Laccetti in November 2004, emphasized the importance of chargebacks, pointing out that they represent “the single largest reduction of gross sales for most pharmaceutical and healthcare product companies.” Ex. D-36 at 2, 37; R.D. 135 at 246. And so it was at Taro USA. During 2003 and 2004, the two years for which the record provides the data, Taro USA’s recorded chargebacks exceeded all of its other sales allowances combined, surpassing the next largest type of allowance by a margin of four. Ex. L-22 at 14. In 2003 and 2004, respectively, Taro USA recorded about \$150 million and \$200 million in chargebacks out of total sales adjustments of \$270 million and \$330 million, on gross sales of \$550 million and \$580 million; the next highest sales allowance was rebates, approximately \$33 million and \$50 million. *Id.* At year end 2003, chargebacks stood out as the largest component of accounts receivable reserves by a more than two-to-one margin, at \$18.6 million, 45% of the total reserves, and 12% of gross receivables. Laccetti’s only apparent reason for changing plans and “audit[ing] [the chargeback reserve] as a component of the A/R allowances in total,” rather than “independently,” was that Taro USA did not supply a detailed calculation for chargebacks. *See id.* at 20, 22; Ex. L-1 at 3. The very inability to supply such a calculation reinforced the distinctiveness of that part of accounts receivable allowances.

The record indicates that Taro USA did not identify a clear methodology or approach to estimating accounts receivable allowances as a whole or chargebacks that Laccetti could readily have tested. Laccetti has cited the following general language in the Revenue Recognition Memorandum as reflecting his understanding of management’s process for estimating accounts receivable allowances as a whole: “These revenue reductions”—“[p]rovisions for sales discounts, and estimates for

chargebacks, rebates, damaged product returns, and exchanges for expired product”—“are established by the Company’s management as its best estimate at the time of sale based on historical experience adjusted to reflect known changes in the factors that impact such reserves.” Ex. D-63 at 8; see Ex. D-109 at 1, 3; Ex. D-112 at 1-2; see Ex. L-178 at 8 (virtually identical language in an April 25, 2005 Memorandum co-written by Laccetti on the \$20 million special reserve).^{9/}

Laccetti described the chargebacks aspect of the company’s estimation process in no more detail than the more comprehensive aspect of its process, distinct from estimation of individual allowances, that he claims Taro USA used to estimate accounts receivable allowances as a whole and to develop the chargeback estimate. Namely, Laccetti testified, “My understanding was they looked at the chargeback allowance by just looking up the processed chargebacks.” R.D. 139a at 1014. The hearing officer aptly described as “sketchy and extremely general” (I.D. 67) another description of Taro USA’s estimation process provided by Laccetti (R.D. 139a at 907):

Our understanding of their chargeback process, similar to most of their other accruals, is they would look at their historical experience, which would be the actual chargeback credits processed and issued, consider any trends similar to what I pointed out in the billbacks that they are one-off promotions or something along those lines. Then they would utilize that data, and in their judgment as to what they expected to issue in the future they would make an allowance for or an estimate for the allowance for chargebacks.

The same picture of Taro USA’s estimation process emerges from testimony, cited by Laccetti, in which he asserted that, “[a]s we applied procedures to the allowance as a whole, we considered the chargeback and how that reserve related to the total” (R.D. 139a at 910) and in which the audit team’s senior manager asserted in the investigation that Taro USA “looked at the overall AR, gross AR to the total allowances and evaluated the chargebacks historically based on that” (Ex. L-181 at 20).^{10/}

^{9/} The parent company’s Form 20-F for 2003, to which Laccetti would have had access during the 2004 audit, used similarly general language: “We base our estimates for these sales allowances”—“product returns, rebates, chargebacks, and other sales allowances”—“on a variety of factors, including actual return experience of products returned, rebate agreements for each product and estimated sales by our wholesale customers to other third parties who have contracts with us....We conduct a review of the factors that influence our estimates periodically. When we find that actual product returns, credits and other allowances differ from our established reserves we make the necessary adjustments.” Ex. J-1 at 47, 121.

^{10/} Laccetti’s argument that Taro USA had the same revenue recognition policy as in prior years, had been audited then by an engagement partner with “extensive

Beyond this, the record shows that, in planning the 2004 audit, Laccetti noted that Taro USA's "accounts receivable allowance estimation process" was "an area of significant subjectivity." Ex. J-29 at 6. The audit team's calculation of "Total A/R Reserve" at "12/31/2004" in a work paper cited by Laccetti (R.D. 180 at 38) was simply the mathematical sum of the individual accounts receivable reserves recorded by Taro USA at year end 2004, not an analysis of estimation methodology. Ex. L-22 at 2.

Any concerns arising from known general weaknesses and limitations in Taro USA's estimation processes, and from known stresses on those processes particular to 2004, applied with special force to its estimation of accounts receivable allowances as a whole and chargebacks. In planning the 2004 audit, Laccetti noted that "[m]anagement's estimation processes for accounting estimates have historically not been strong." Ex. J-29 at 6. Aware from auditor comments after a prior Taro USA audit that "the estimation of certain allowances and accrued rebates/billbacks are based on sales volume, promotions, and inventory levels on hand with wholesalers servicing third parties,"^{11/} he knew that its agreements with wholesalers did not "give[] information about the stock levels at the wholesalers." Ex. D-234 at 2. In fact, the 2003 audit team, including Laccetti, had tried to obtain such information from Taro USA, without avail, prompted by a major pharmaceutical company's recent restatement due in part to improper revenue recognition based on estimates relating to inventory at wholesalers. See Ex. L-180 at 27-28, 32-34; R.D. 180 at 18 ¶ 45. That year, the team increased the combined risk assessment for Taro USA's valuation assertion of accounts receivable allowances from moderate to high, and Laccetti carried this over to the 2004 audit. Ex. D-3 at 8; Ex. D-72 at 9. Again to no avail, he asked Taro USA during that audit for data

experience and expertise regarding both the industry and the client," whose work underwent high-level review by an experienced independent reviewer at Ernst & Young, and "had not had any revenue recognition issues in the past" (R.D. 180a at 167-68; R.D. 180 at 71) does not show that the auditors in those prior years knew anything more, or more favorable, about Taro USA's estimation process than Laccetti, nor does it address the circumstances particular to the 2004 audit. See, e.g., I.D. 112 n.48. The statement in AU § 342.09 that an auditor "normally should consider the historical experience of the entity making past estimates as well as the auditor's experience in the industry" requires consideration on the auditor's own part and does not mean simply deferring to a prior audit report, no matter how esteemed its pedigree may be.

^{11/} Ex. J-27 at 4; see R.D. 137 at 797-99 (Laccetti); see also Ex. J-1 at 15, 47 (Taro USA's parent company's Form 20-F for 2003) ("We base our estimates for [our] sales allowances on a variety of factors, including...estimated sales by our wholesale customers to other third parties who have contracts with us. Actual experience associated with any of these items may differ materially from our estimates.").

on wholesaler inventories, according to investigative testimony he cites of the senior manager. Ex. L-181 at 21-25.^{12/}

Furthermore, Taro USA did not provide Laccetti with a promised "analysis of the overall realization of [its 2004] accounts receivable (cash collections as a percentage of gross accounts receivable)" (Ex. D-72 at 6). R.D. 135 at 314, 372. Nor could it provide "lag reports related to subsequent cash receipts or accounts receivable allowances." Ex. D-100 at 1. An analysis of the lag between cash collections or sales allowance claims and the sales to which they related could have been used to assess collections and exposure to future claims based on past sales. Laccetti knew that, "[i]n some instances," Taro USA had difficulty matching credits with actual invoices, could not "in all cases" produce reports to match sales with allowances, and, in particular, did not compile a detailed calculation for the year-end 2004 chargebacks reserve because, according to management, "it was difficult to identify sales and chargebacks." R.D. 135 at 210, 443; R.D. 139a at 1013-14. Indeed, Taro USA overpaid millions of dollars of chargebacks in the six months or so since July 2003 because those credit claims had not been matched to the sales generating them. And it had explained to Laccetti that the cause of the "lack of order" in providing support for the reserves during the 2004 audit was "the drop in sales in Q2" 2004. Ex. D-234 at 2. The principal auditor had identified this "substantial decrease in sales" to Laccetti as a "material change in business" and "change[] in significant accounting and audit issues" from 2003, and Laccetti viewed the sales drop as "dramatic[]." Ex. J-26 at 3, 6; Ex. J-29 at 7.

As Laccetti also knew, the auditors commented in connection with the 2002, 2003, and 2004 audits that Taro USA lacked "a formalized process for the preparation

^{12/} Indicating additional limitations on Taro USA's estimation of the allowances, the parent company's December 2004 response to SEC staff stated that, "[w]hile we do monitor third-party data as to prescriptions written, historical experience leads us to believe that such data is not indicative of what our customers' purchase orders will be" and it "is the only" data "that we generally utilize" from external sources such as end-customer prescription demand or third-party market research data comparing wholesaler inventory levels to end-customer demand. Ex. D-44 at 3-4; see Ex. D-261 at 3 (Taro USA February 24, 2005 press release indicating use of prescription data to broadly gauge trends in its direct sales). The mid-2005 supplemental response continued to indicate that the parent company made no more than limited, high-level use of prescriptions data in estimating sales allowances. See Ex. D-294 at 5 ("Based on our analysis of third party data indicating the continued increase in the number of prescriptions filled with our products and the increase in the number of units sold by wholesaler customers (as they were submitted to us), we viewed the reserve levels at the end of [2003] to be adequate."). The only reference to such data in the audit testing of Taro USA's 2004 accounts receivable reserves appeared in a memorandum (Ex. L-178) about the \$20 million special reserve not in question here.

and review” of accounts receivable allowances that would “facilitate a more timely and accurate calculation of these accounts as well as provide consistent application from period to period”; that “would establish a consistent method of determining the allowances and also assist management in providing monitoring information for review and control of the accounts receivable”; and that “would provide a basis for monitoring customer trends and performance by line of business as well as monitor the effectiveness of the Company’s credit and collection practices.” Exs. J-25 at 3, J-27 at 4, D-18 at 2, D-21 at 3 (post-audit letters from the auditors to management); R.D. 135 at 217-19, R.D. 137 at 799-801, 807-08, R.D. 139a at 954-56, 975-76, 1050, 1064-65 (Laccetti); R.D. 141 at 1447-49 (principal auditor’s engagement partner).

Conditions reached the point during the 2004 audit that Laccetti elevated Taro USA’s lack of a formalized process to a deficiency that needed to be communicated to the audit committee as a reportable condition. This was despite management representations to the auditors after the 2002 and 2003 audits, known to Laccetti, that there were monthly and quarterly reviews of all reserves and “constant communication” between finance and accounting staff and the sales and marketing department (Ex. J-27 at 4) and that the company “is documenting a formal policy for a number of items,” including “accounts receivable reserves” (Ex. D-21 at 3). As a result of the process issue, the Taro USA audit team did not rely on internal controls testing to assess the allowances. The final Summary Review Memorandum for the 2004 Taro USA audit, approved by Laccetti, stated that Taro USA’s “accounts receivable reserve estimation methodology has not been defined and monitored for the most updated trends” and that the audit team had to “expand[] our procedures” to try to compensate for the deficient process and “gain comfort that the amounts were properly recorded at net realizable value.” Ex. R-7 at 4. During work on the 2004 audit, Laccetti was highly critical of Taro USA’s estimation process for accounts receivable allowances, variously writing that the company had “a lack of process for establishing an AR reserve,” “no formal methodology to test,” “no process for creating an estimate,” “no method[o]logy or process for making a sound estimate of AR allowances,” and “no real basis for the amounts they record.” Ex. J-5 at 1; Ex. D-100 at 1; Ex. D-114 at 1; Ex. D-116 at 1. Although Laccetti noted in one of these same emails that the audit team “did receive some information [from Taro USA] late in the process” (Ex. D-116 at 1), the auditors never received any “detailed calculation” or “specific” estimate for accounts receivable allowances as a whole or for chargebacks during the 2004 audit.^{13/}

^{13/} Whether, as Laccetti argues generally, lack of a formalized estimation process was “quite common” at the time, before wider implementation of “the sweeping internal control reforms that were ushered in with the Sarbanes-Oxley Act of 2002” (R.D. 204 at 3), is not the issue. We reject, as did the initial decision, any argument by the Division that “informal and undocumented procedures” must be “equivalent to unreliable procedures, or, indeed, to no procedures at all.” I.D. 25. Rather, the issue is that the particular discussions in the record by or known to Laccetti about Taro USA’s lack of a

Given these circumstances, there can be no doubt that Laccetti's understanding of, and determinations about, Taro USA's deficient estimation process for total accounts receivable allowances heightened the rigor demanded of the overall audit work on management's ability to estimate and on the estimate's reasonableness.

B. Analysis of the Audit Testing of the Accounts Receivable Allowances

PCAOB standards require an auditor to obtain and evaluate, with due professional care, including professional skepticism, sufficient competent evidential matter to form conclusions concerning the validity of the individual assertions embodied in the components of the financial statements (or here a financial reporting package) and to support significant accounting estimates in an audit of financial statements. *E.g.*, AU § 150, 230, 326, 342. Based on an understanding of how management developed the estimate, the auditor should review and test that process, develop an independent expectation of the estimate to corroborate the estimate's reasonableness, or review subsequent events or transactions occurring prior to completion of fieldwork to identify and evaluate the estimate's reasonableness or key factors or assumptions used in its preparation, or use a combination of two or all three of these approaches. AU § 342.10.

The procedures adopted by the auditor "should be adequate to achieve the auditor's specific objectives" and reduce to an acceptable level the risk that a material misstatement may go undetected. AU § 326.13. Management representations are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for the audit opinion. AU § 333.02. Analytical procedures are "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data," and "involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor." AU § 329.02, .05. Expectations developed in analytical procedures used as substantive tests during the audit "should be precise enough to provide the desired level of assurance" that differences from that expectation that may be potential material misstatements would be identified. AU § 329.17. Expectations "developed at a detailed level generally have a greater chance of detecting misstatements of a given amount than do broad comparisons." AU § 329.19. For significant risks of material misstatement, "it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient." AU § 329.09.

Laccetti used a combination of procedures to evaluate the reasonableness of Taro USA's 2004 accounts receivable allowances. Consistent with his audit approach

formalized process—which, we agree with the initial decision, did not "concern[] merely the documentation of existing procedures" (*Id.*)—were part of Laccetti's understanding of Taro USA's estimation process, did not help support the estimates, and affected the audit work necessary to address the risk that the estimates were materially misstated.

of assessing Taro USA's estimated sales allowances by performing substantive procedures on the year-end accounts receivable reserves and not on the 2004 reductions of gross to net sales, the audit work at issue concerns those reserves (or allowances). As summarized at the end of the Accounts Receivable Allowances Memorandum, "[a]lthough management did not prepare a specific chargeback estimate, based on our procedures performed above on the detailed calculations [that Taro USA did provide for the other individual sales allowance reserves] and the overall realization of accounts receivable, the allowances at December 31, 2004 appear reasonable." Ex. L-22 at 22. This description is consistent with the investigative testimony of the senior manager of the 2004 Taro USA audit, cited by Laccetti, that "we had done substantive procedures related to the other allowances [than chargebacks], and...we had evaluated the AR allowances in total, [and] that was how we, so to speak, got comfortable with—felt [the reserve in total and for chargebacks] was reasonable." Ex. L-181 at 53-54.

This audit work consisted of testing individual accounts receivable reserves other than chargebacks; comparing the year-end chargebacks reserve balances for 2003 and 2004 and inquiring about the change; performing analytical procedures to test the year-end total reserves balance; and considering the results of confirmation testing of certain unpaid invoices on Taro USA's interim aging report and analysis of certain receivables on its year-end aging report. See, e.g., Ex. D-125 at 2-4; Ex. L-22; Ex. L-23 at 21-29-30; Ex. L-24; Ex. L-110 at 46-52; Ex. L-178 at 3-10; R.D. 139a at 952-53, 1014-15.

We agree with Laccetti that, to the extent the Division contends he inadequately assessed individual allowances other than chargebacks, the Division did not address that audit work in enough detail to prove a deficiency. But we discussed above evidence of the distinctiveness of the chargebacks allowance, and Laccetti himself does not contend that the audit testing of the individual allowances other than chargebacks sufficed to evaluate the total accounts receivable reserves balance. Indeed, other than broadly asserting that "procedures performed on the components also necessarily assessed the overall reserve as well," simply because "these components were all part of the total accounts receivable reserve" (R.D. 204 at 7, 8), he offers no analysis for why or how, in the context here, the audit work on the other individual allowances supported the total. The record shows that the audit work on the individual allowances other than chargebacks, while not proven to be deficient in its own right, nevertheless did not contribute sufficient audit evidence for the evaluation of the rest of the total balance.^{14/}

^{14/} The audit testing of the detailed calculations Taro USA provided for the individual allowances other than chargebacks did not particularize how it estimated, or specifically test its estimates of, accounts receivable allowances as a whole or chargebacks. That testing showed only that, in a widely varied manner, management used certain data, allowance-specific databases, percentages or averages, one-off adjustments, and broad sales trends in estimating particular allowances for which a calculation was provided. The data included Taro USA's processed credits and sales data for

At the end of 2004, the chargebacks reserve was glaringly out of line with the prior year. Laccetti has acknowledged that, at least initially, the total reserves balance appeared inconsistent with other Taro USA financial data he considered. See, e.g., R.D. 139a at 1012-13. Having not received any detailed explanation or calculation of the chargebacks reserve from Taro USA (including in its replies to SEC staff inquiries), and in light of the company's 2004 circumstances, Laccetti should have viewed the one-year 87% drop in the reserve for that major Taro USA sales allowance to only \$2.37 million as casting doubt on the adequacy of the total reserves balance. Yet he accepted what to him should have been a patently unreasonable explanation for the decrease.

When planning the 2004 audit, Laccetti made the judgments to use analytical procedures as substantive tests during the audit (see AU § 329.09-.22) in assessing Taro USA's accounts receivable allowances; not to rely on substantive testing of income statement items as part of the testing of the company's sales allowance estimates; and not to rely on internal controls testing as to the estimates. See, e.g., Ex. L-1 at 3, 6; Ex. L-110 at 46-49; Ex. J-29 at 8; R.D. 135 at 315-17, 322. In trying to move from an evaluation of the reasonableness of the individual allowances for which detailed calculations existed (see, e.g., Ex. D-72 at 6; Ex. L-110 at 46-52) to an evaluation of the reasonableness of the total allowance balance, Laccetti relied heavily on substantive

estimating many of these allowances; third-party sales data electronically submitted to Taro USA by wholesalers and distributors for estimating some of them; and another company's sales data, information obtained from an outside service about prescriptions written for that company's products, and other data in estimating a special reserve, not in question here, for sales of products by the other company before Taro USA acquired those new product lines from that company in July 2004. See, e.g., Ex. L-24 at 2, 3, 9, 42, 44, 77, 147, 148, 167, 169, 172; Ex. L-22 at 17-21; Ex. L-178 at 3-4, 6-7; R.D. 139a at 903-04, 911-15, 921-22. This was broadly consistent with general descriptions of the allowances prepared by Taro USA's parent company for SEC staff in late 2004 and mid-2005, in response to SEC staff comment letters on the company's Form 20-F for 2003, and copied to Laccetti. Those responses represented that management "determined the amounts to accrue and reserve subjectively, on the basis of our decades-long historical experience" (Ex. D-44 at 3); that "the substantially most determinative factor that we consider in establishing accruals and reserves is our historical experience" (*id.*); and that "we monitor the inventory in the [distribution] channels based on customers' orders, customers' submissions of their sales to third parties, third party reports of prescriptions written, third party sales data, and our experience and historical data, including the amounts and levels of actual returns and rebates" (Ex. D-294 at 6). As with the audit review and testing of Taro USA's process of developing each sales allowance estimate for which a detailed calculation was provided, analytical procedures performed on those estimates provided information particular to them. See, e.g., R.D. 204 at 7-8. And the audit work on subsequent events in the allowances area tested only the largest product return and the three largest rebates. See p. 20 above.

analytical procedures, in the form of trend analyses, to test the total. In doing so, he was hampered by Taro USA's lack of identification of a clear methodology or approach for estimating accounts receivable allowances as a whole and chargebacks that he could have readily tested and therefore in his ability to "independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors" to "corroborate the reasonableness of management's estimate" (AU § 342.10b, .12). Typically, he used the prior year's balance as his expectation.

Laccetti's days sales in accounts receivable—DSR—analysis was badly flawed. Instead of viewing the original analysis, showing a jump in DSR from 111 days in 2003 to 171 days in 2004, as an indication the chargebacks reserve—the only individual reserve not subject to direct, detailed audit testing—might be materially understated, Laccetti selectively adjusted the 2004 DSR downward and, without explanation, shifted the basis for comparison to 2001 and 2002. The other analytical procedures he cites are too general to bear the heavy weight placed on them to assess total reserves.

Finally, the evidence about the audit testing or analysis of the aging reports does not show either how this work would have addressed the sales allowance reserves or how it reached beyond the reserves that were tested individually to the rest of the balance. In fact, the record indicates severe limitations on the ability of that work to have addressed the adequacy of Taro USA's estimation of the overall balance.^{15/}

^{15/} Laccetti asserts that it was the totality of the audit procedures, analysis, and evidence regarding Taro USA's 2004 accounts receivable reserves as a whole that formed the basis for his conclusion that the total reserves balance appeared reasonable. R.D. 204 at 6-7 & n.10; R.D. 210 at 18, 21 & n.18. Nonetheless, Laccetti's own statements and arguments concede the importance of the analytical procedures in the mix. See, e.g., R.D. 210 at 18 (Laccetti's brief chose to summarize the audit work on the reserves as follows: the audit team "decid[ed] to evaluate the overall reserve as the significant accounting estimate," "performed procedures on the components of the overall reserve," and "performed analytical procedures on the reserve as a whole"); R.D. 204 at 8 (other than audit "analyses of individual components of the accounts receivable reserve" and the Taro USA "divisional analysis," discussed above, Laccetti's brief specified "several analytical procedures" in support of the accounts receivable allowances as a whole); R.D. 180a at 203 (Laccetti argued that, as distinct from "assess[ing] the objective data [the company] used in developing the estimates of various components of accounts receivable allowances," it was "through the performance of several analytical procedures" that he "developed an independent expectation of the accounts receivable allowances as a whole to corroborate the reasonableness of management's estimate, thus assessing both the subjective and objective factors used to develop the estimate," as required by AU § 342.04); Ex. D-100 at 1-2 (citing Taro USA's inability to "give us lag reports related to subsequent cash receipts or accounts receivable allowances" and the fact that the company had "no

1. Consideration of decrease in chargebacks reserve balance

In the 2004 Taro USA audit, the only audit testing specific to the year-end chargebacks reserve was comparing the reserve balances at the end of 2003 and 2004 and considering management's representation that the \$16.3 million decrease in the reserve over that period was due to an estimated \$11 million in excess chargebacks that Taro USA had mistakenly paid to wholesalers and expected to recoup. This procedure was identified in the Accounts Receivable Allowances Memorandum. That memorandum was the only work paper the audit team referenced in connection with the planned work steps for testing chargebacks reserve individually, other than the lead sheet comparing the year-end reserve balances (Ex. L-22 at 2). Ex. D-46 at 46-47. And other than the comparison of the balances, the only discussion in the memorandum about chargebacks testing was a reference that "the chargeback reserve was audited as a component of the A/R allowances in total." Ex. L-22 at 20; see R.D. 137 at 498-99.

The steep, one-year drop in the chargebacks reserve, coupled with a management explanation for why the reserve was nonetheless adequate that, as we discuss below, was unreasonable, based on what Laccetti knew, undermined, not supported, the reasonableness of that reserve. And this was the part of the total reserves balance about which Taro USA did not provide specific information and which was not subject to direct, detailed audit testing. These circumstances signaled "the clear need for increased care and skepticism." *Gregory M. Dearlove*, SEC Rel. No. 34-57244, 2008 SEC LEXIS 223 at *51 (Jan. 31, 2008) (SEC proceeding against auditor under Rule 102(e) of the SEC's Rules of Practice, governing appearance and practice before the Commission, for improper professional conduct), *petition denied*, 573 F.3d 801 (D.C. Cir. 2009). Laccetti's acceptance of management's representation without exercising increased care and skepticism itself violated PCAOB standards.

Chargebacks was Taro USA's single largest sales discount. Of the 49% and 57% that sales adjustments reduced its gross sales in 2003 and 2004, respectively, chargebacks alone accounted for 27% and 35% of those reductions. Ex. L-22 at 14-15. At the end of 2003, chargebacks represented 45% of total accounts receivable reserves and 12% of gross receivables, and was more than twice the size of the next largest reserve. *Id.* at 2. There was reason to expect similar results a year later. According to Laccetti, Taro USA considered "the actual chargebacks credits processed and issued [and] any trends" in estimating the reserve. R.D. 139a at 907. By year end 2004, gross sales grew by \$28 million. Ex. D-63 at 62; Ex. L-22 at 14-15. Recorded chargebacks rose by 34% and constituted 7% more of total sales adjustments, which generated the reserves. *Id.* at 14-15. The gross receivables covered by the total year-end reserves increased by \$12 million, which again suggested the chargebacks reserve should have

formal methodology to test," Laccetti wrote to the principal auditor that "it is difficult to review appropriateness of allowance without looking at trends and specific accounts").

risen. *Id.* at 8. The total reserves grew by \$1 million. *Id.* at 2, 8. Every individual reserve increased, except for chargebacks, cash discounts (slight decrease), and two of the smallest accounts ("Accrued Expenses—Misc.," from \$.7 million to \$.5 million; and "Allowance for Bad Debts," from \$.1 million to \$.05 million). Ex. L-22 at 2, 17-21.

Yet, over the same one-year period, Taro USA's chargebacks reserve fell 87%, from \$18.6 million to \$2.37 million, becoming one of the smallest reserves, at under 6% of total reserves and under 2% of gross receivables. About the drop, the audit work paper containing this data stated only, "Chargebacks was considered in the audit of A/R reserves as a whole. See E Memo—AR Allowances." Ex. L-22 at 3. All the referenced Accounts Receivable Allowances Memorandum added was: "The chargeback reserve decreased by \$16.27 million from prior year, while over the same period, gross trade accounts receivable increased by \$11.9 million. The decrease was due to the excess chargebacks given to wholesalers in 2003 in which over \$10 million was subsequently collected in 2004." *Id.* at 20. The initial decision aptly described the latter statement as cryptic, deficient, inadequate, and insupportable. I.D. 69, 71, 81, 111.

At the hearing and in his post-hearing submissions, Laccetti was unable to provide any coherent description of his understanding of that statement, and he does not address it in his briefing on appeal. See, e.g., R.D. 139a at 1016-18; R.D. 130a at 82, 181. The explanation was inadequate for multiple reasons. First, it did not explain why \$11 million in excess chargebacks caused the reserve to fall by \$16.3 million. Second, it did not explain why Taro USA left the year-end chargebacks reserve at the level to which an error had reduced it. During the period Taro USA had been allowing the excess chargebacks, that mistake had been depleting the reserve for the rest of the chargebacks: "The Company discovered [its] mistake in the first quarter of 2004 as cash decreased and the chargeback reserve decreased." Ex. L-106 at 1 (Summary Review Memorandum for quarter ended March 31, 2004); Ex. D-72 at 5 (Audit Strategies Memorandum for 2004). As Laccetti knew, the only audit evidence of a response to this problem of an understated reserve was that Taro USA "increased accounts receivable for the entire \$11 million" in estimated excess chargebacks and "also reserved the entire amount." *Id.* But, at year end 2004, it ceased recording the \$11 million reserve, while maintaining the \$11 million receivable. *E.g.*, Ex. D-88 at 3.

Management's reference, as reported by the audit team, to its having "collected \$10 million" of other, once-disputed sales allowance claims from the wholesalers seemed to treat collectability of the \$11 million receivable as though it were the same issue as the adequacy of the chargebacks reserve. Similarly, the Accounts Receivable Memorandum discussed the inclusion of the \$11 million in gross receivables without any offsetting reserve, but said nothing about the decrease in the chargebacks reserve: "correspondence has been sent to the wholesalers to recover these amounts"; and management "has informed us that [it is] in the process of negotiating new General Wholesale Service Agreements with [them] and that [it] expect[s] to receive this money in 2005" and "if [it is] unable to receive direct payment from the wholesalers that [it] will

reduce chargebacks or discounts given to wholesalers to eventually satisfy the receivable balance," which the audit team deemed reasonable since "incorrect excess chargebacks were given to the wholesalers in the first place" and "a negotiation of reduced chargebacks is a good possibility," as "chargebacks are a normal part of [the US subsidiary's] business process." Ex. L-22 at 5-6; see R.D. 180 at 73 (Laccetti argues he "obtained corroborating documentation as to the collectability of approximately \$11 million in chargebacks"), citing Ex. R-12 at 3 (Taro USA management representation letter, dated February 18, 2005, stating, "We acknowledge our responsibility for the not recording any allowances or reserves on \$11 million in accounts receivable that relates to excess chargeback's paid to Wholesalers in 2004. We believe this amount is fully collectible and should be received in the next year.").

Even if that discussion might be read to justify maintaining the receivable (for expected direct payments of \$11 million) or reducing the reserve (for expected reductions of future chargebacks covered by that reserve by \$11 million), it would not explain doing both at the same time, without any evidence that the reserve had been replenished from its initially depleted state. Viewing the \$11 million that was initially added to the reserves as addressing the prospect for recouping the overpayments—as later elimination of that amount from the reserves based on the status of negotiations with the wholesalers indicated—merely addressed the collection risk associated with that particular means of satisfying chargebacks claims. It did not address the restoration of the chargebacks reserve to the level necessary to cover all of the probable chargebacks claims on sales through the end of the year under audit. If that reserve were restored to that level, it would, in theory, offset the \$11 million receivable dedicated to those claims. But reducing the reserves by \$11 million and including an \$11 million receivable double-counted the \$11 million, as Laccetti himself seemed to concede at the hearing. See R.D. 139a at 1020.

Furthermore, even if Taro USA recovered the \$11 million—by whatever means—there was an even deeper problem with management's explanation for why the company's recorded year-end chargebacks reserve was reasonable. Laccetti, in trying to justify his acceptance of management's representation about the decrease in the chargebacks reserve, which relied on the \$11 million figure, essentially contends that the \$11 million reasonably approximated the amount by which the chargebacks reserve had been depleted by Taro USA's overpayments of chargebacks. But in trying to explain why he did not treat the estimates of wholesaler inventory on which the \$11 million figure was based as a factor in his audit assessment of Taro USA's sales allowance estimates, Laccetti took a contradictory position that only exposes how little care and attention he devoted to the level of the year-end 2004 chargebacks reserve.

The excess chargebacks resulted from Taro USA's processing of chargebacks claims made by its three largest wholesalers at the higher price it charged them as of July 1, 2003, rather than at the pre-July 1 actual purchase price. In the quarterly review for the period ending March 31, 2004, the 2003 Taro USA audit team, including Laccetti,

explained that “[a]ny inventory held at July 1, 2003 would have been purchased at a lesser price and therefore entitled to a smaller chargeback than was submitted.” Ex. L-106 at 1. To estimate the amount of inventory, Taro USA obtained June 1, 2003 inventory levels at one of the wholesalers and added June 2003 purchases to extrapolate the figures to July 1, 2003; and, lacking inventory data for the other two wholesalers, it assumed that the purchases from the six months before July 1, 2003 were still in inventory and calculated the excess chargebacks based on six or, in the case of one wholesaler, only four months of sales data. *Id.*; Ex. L-107 at 1-3; Ex. D-23. Then, Laccetti maintains, Taro USA used the calculations, based on “this unreliable inventory assumption,” for “the sole purpose of negotiating with wholesalers to recover the excess chargebacks Taro US had paid to them,” not for the parent company’s year-end financial statements. R.D. 180 at 22-23 (citing R.D. 139a at 946-47, 1016-18).

By Laccetti’s account, Taro USA “worked up a rough method of estimating how much money it had overpaid in chargebacks to the wholesalers,” based in part on “rudimentary sales analysis,” and this “not rigorous” and “rough estimate of its overpayment of chargebacks”—the \$11 million—was “crude and unsuitable for use” in connection with the issues of accounts receivable estimations and revenue recognition related to Taro US’s financial reporting package (and the [Ernst & Young] team’s audit of that financial reporting package). R.D. 180 at 22; R.D. 180a at 182-83, 223. Laccetti explained that the estimate was based on “mostly just sales data and assumptions of how much potential inventory might be entailed” and that “[s]ales data alone” would not be used for a reasonable estimate of the chargebacks reserve because it “[j]ust tells you how much the particular customer purchased.” R.D. 139a at 946-47. Laccetti claimed he did not use the estimate in any way for purposes of testing Taro USA’s sales allowance reserves during the 2004 audit. *Id.*; R.D. 135 at 345-46.

The fact is, however, that Taro USA did not use the inventory estimates and resulting \$11 million figure “for the sole purpose of negotiating with wholesalers to recover the excess chargebacks” but also to explain the drop in the chargebacks reserve by year end 2004. And the fact is that, during the audit, Laccetti did not treat the \$11 million figure, or the negotiations, as “unsuitable” for assessing the chargebacks reserve. Rather, they were critical to his acceptance of management’s representation about the decrease in the reserve. The mere fact that the wholesalers, in ongoing negotiations with Taro USA, appeared willing to accept the “crude” and “rough” \$11 million figure did not constitute an audit assessment that it reasonably approximated the amount by which the chargebacks reserve had been depleted by the excess chargebacks—an assessment Laccetti never made, despite its relevance to management’s representation that the diminished reserve was adequate at year end.

Laccetti argues that, in addition to the management representation just discussed, he considered an assertion by Taro USA that the increase in its sales of branded products in 2004 affected the level of its sales allowances that year. R.D. 204 at 10. This claim is based on: (1) high-level generalities offered in his testimony that

"the more branded products that [Taro USA] sell[s]," which are subject to less competition than generic products, "the fewer discounts that are needed" (R.D. 139a at 925-27); and (2) "Divisional Accounts Receivable" schedules at the bottom of the 2003-2004 annual and 2004 quarterly Accounts Receivable Summary work papers (Ex. L-22 at 8-11). The schedules broadly categorized year-end 2003 and 2004 receivables into branded and generic products, calculated that the branded category had grown from \$2.5 million to \$17.9 million since year end 2003, while overall gross receivables had grown by \$12 million to \$165.5 million, and adjusted the accounts receivable reserves at the end of 2003, 2004, and each quarter of 2004 by multiplying the amount of branded receivables by 2% and subtracting that amount from the reserves, representing the cash discounts for timely payment offered on all Taro USA sales. *Id.* Laccetti testified the purpose of the calculations was to corroborate its assertion that its sales of branded products were rising and to compare the adjusted reserves, as a percentage of non-branded receivables, at period end, to see if they were "in line." R.D. 139a at 925-26.

There is no evidence that any discussion or consideration of Taro USA's so-called divisional analysis focused specifically on the reduction in the chargebacks reserve, and Laccetti has appeared to concede as much (see R.D. 137 at 497-99; R.D. 204 at 10 n.13). Further, it did not analyze the growth in Taro USA's branded sales or receivables, which remained a relatively small part of total sales and receivables, in the context of other developments, to determine the overall effect, if any, on the level of the year-end 2004 sales allowance reserves, much less explain a disproportionate effect on chargebacks. As Laccetti recognized, Taro USA "did not provide a divisional analysis for the accounts receivable reserves," only breakdowns of gross sales and gross receivables into the categories of branded or generic product. R.D. 180a at 136.

Laccetti also knew that, over the same period that the divisional data showed the rise in branded sales, generic sales, which were "the biggest component of [Taro USA's] sales year over year," and were fully subject to sales allowances, held steady (were "flat"). R.D. 139a at 925; Ex. D-63 at 59-62. And he knew that total sales adjustments and related total year-end reserves for 2004 each grew, as did essentially all of the major individual reserves except for chargebacks. Ex. L-22 at 2, 8, 14. In addition, Laccetti's audit work on the \$20 million special reserve, which covered sales of branded products by another company before Taro USA acquired the right to sell them in July 2004, showed that chargebacks and other allowances were offered, to some extent, on sales of such products, and to the same large wholesalers Taro USA utilized. Ex. L-178 at 3, 4; see generally, e.g., Ex. J-1 at 17 (Taro USA's parent company's Form 20-F for 2003: "Even if launched commercially, our proprietary products may face competition from existing or new products of other companies."); R.D. 135 at 435-37 (2004 Taro USA audit team did not review significant contractual terms or credit memo patterns for chargebacks, see Ex. D-125 at 4). Thus, even if there were evidence that Laccetti considered the divisional analysis in connection with the decrease in the chargebacks reserve, the analysis was too cursory to help explain the large decrease.

Despite cause for concern about the chargebacks reserve from his own audit procedure, Laccetti did nothing further to investigate management's explanation for the decrease. Indeed, once Taro USA told him it was "difficult" to match chargebacks to the sales giving rise to them and did not supply a detailed calculation for that reserve, he made no other attempt to specifically test the chargebacks allowance. He abandoned all other planned procedures to do so, including "[d]etermin[ing] reasonableness of reserve for chargebacks by calculating chargebacks as a percentage of sales"—which would have shown the chargebacks reserve was less than 5% of gross accounts receivable, while the amount of chargebacks as a percentage of gross sales was 35% (Ex. L-22 at 2-3, 14-15); "analyzing trend of chargebacks using the September and December aging and the most recent aging"; and "[o]n a test basis compar[ing] amounts accrued to contracts for reasonableness."^{16/} Although Laccetti claimed to understand that Taro USA "looked at the chargeback allowance" by reviewing "the actual chargeback credits processed and issued" (R.D. 139a at 907, 1013-14), he undertook

^{16/} We note, as a factual matter, that Laccetti does not explain his abandonment of the planned procedures beyond suggesting, without explanation, that it was related to Taro USA's failure to provide a detailed calculation for its year-end 2004 chargebacks reserve; stating the general point that "changes to the audit plan as the audit is carried out is a standard occurrence"; and broadly asserting that "contrasting balance sheet ratios and income statement ratios" or "comparing processed and estimated allowances" would be "inappropriate with respect to Taro US" simply because there was not a "one-to-one predictive relationship" between them. *E.g.*, R.D. 180a at 61-62, 68, 77, 79, 80-81, 95, 183, 191, 230. The last point is inconsistent with other positions taken in the 2004 audit. For example, the work papers show that, in testing Taro USA's year-end 2004 returns reserve, the audit team "reviewed the calculation and performed analytics noting that the allowance for returns as a percentage of gross sales is 2.08% for 2004 and 1.37% for 2003," which is "consistent as a percentage of gross accounts receivable." Ex. L-24 at 2. Moreover, Laccetti has repeatedly asserted that Taro USA relied on "processed sales adjustments" in establishing individual accounts receivable reserves, including chargebacks, and that the team "reviewed processed credits as part of [its] testing" of the other individual reserves. *See, e.g.*, R.D. 139a at 896-907; R.D. 180 at 38-39; R.D. 180a at 169. According to him, "processed credits during the year under audit are relevant historical information for evaluating an estimate, as they may be the most indicative of the current operating environment." *Id.* at 171. Furthermore, the engagement partner for the 2003 audit testified in the investigation to precedent for Taro USA itself having made "a calculation where they took the gross sales" and "the cash receipts for the year, and it showed a percentage of collections on the sales" and "applied that percentage to their outstanding accounts receivable at the end of the year to calculate what they believed was their allowance requirement." Ex. L-180 at 21-22.

no analysis of any chargebacks claims it received and processed and no assessment of chargebacks claims likely to be, or in fact, received after 2004 based on prior sales.^{17/}

Therefore, other than comparing the chargebacks reserve balance at the end of 2003 and 2004 and, without proper consideration, accepting Taro USA's insupportable explanation, Laccetti did nothing else to test the year-end 2004 chargebacks reserve itself. Instead, he otherwise relied on procedures performed on the accounts receivable reserves as a whole—to which we now turn—to test this part of the total.

2. Analytical procedures

a. DSR analysis

The Division contends that the days sales in accounts receivable—or DSR—analysis was “the primary procedure” that Laccetti used to test aggregate accounts receivable allowances and was grossly deficient. *E.g.*, R.D. 205 at 7, 23. Laccetti counters it was only one of “several” analytical procedures he used for that purpose, but otherwise does not appear to try to defend it on appeal. R.D. 204 at 6. Regardless of the parties' characterizations, the evidence shows that the DSR analysis played an important role in the 2004 Taro USA audit and that it was seriously flawed.

^{17/} Laccetti cannot dismiss as irrelevant to this case, as he seems to do (*e.g.*, R.D. 210 at 13 n.9; R.D. 180a at 101; R.D. 180 at 10-11), the amount of chargebacks claims Taro USA processed in 2004, because it could well have had implications for the adequacy of the year-end chargebacks reserve. He argues (*id.*) that as Taro USA approved sales allowance claims over the course of the year, it replaced, for purposes of its income statement, the estimated sales adjustments corresponding to those claims with the actual amount of the claims, and, for purposes of its balance sheet, discharged the actual amount of the claims from the appropriate reserves, with the result that by year end, only the sales allowance reserves and a related, relatively small portion of the year's total sales adjustments constituted estimates of future sales allowance claims based on past sales. But Laccetti did not analyze the relationship between processed chargebacks and future chargebacks in the 2004 audit. Similarly, Laccetti understood during the audit that Taro USA did not have inventory information from the wholesalers, did not match chargebacks claims to the sales giving rise to them, did not determine the lag time between the sales and the claims, and did not prepare any detailed calculation, based on processed chargebacks, of the expected amount of future chargebacks. In light of this lack of audit testing and evidence, Laccetti had no basis for simply assuming that the chargebacks processed in 2004 derived only from 2004 sales and largely exhausted the chargebacks that could be expected to arise from the 2004 sales, rather than foreshadowed that a large magnitude of such chargebacks was still to come.

Other than noting the amount by which Taro USA's year-end 2004 accounts receivable reserves had increased, in dollars and as a percentage of gross receivables, and explaining the increase by reference to the \$20 million special reserve, all the Accounts Receivable Allowances Memorandum stated about testing the aggregate reserves was that, "[i]n order to test the adequacy of [the accounts receivable] reserves in total, EY calculated Days Sales in Receivables (DSR) for 2004 and compared it to 2003," then adjusted the DSR downward and deemed it in line with 2001 and 2002. Ex. L-22 at 22. Laccetti recognized that DSR could be an "indication of concerns with reserves." R.D. 139a at 924. Use of DSR to test the reserves is consistent with his expert's description of that analytical procedure as "utiliz[ing] relationships between net accounts receivable (accounts receivable less accounts receivable allowances) and net sales (sales less sales allowances)," such that, "[i]f, for example, chargebacks were under-reserved or actual chargebacks increased, the DSR calculated would increase." Ex. L-179 at 34. But, as his expert stated, the procedure "begins with the expectation that the DSR would remain consistent over the period of review." *Id.*

What the original DSR analysis showed was that from the end of 2003 to the end of 2004 DSR rose sharply from 111 days to 171 days. Ex. L-22 at 8. The 60 extra days extended DSR by 54% and was, in itself, the longest period specified in Taro USA's billing terms for customers to pay invoices. Ex. L-176 at 4 ("Sales/AR/Cash Receipt Narrative Process" Memorandum prepared in 2004 Taro USA audit stated, "Billing terms for the customers vary between 30 to 60 days"). Laccetti concedes the large increase in DSR was cause for concern and was part of the "problems" that led to his initially expressed discomfort with the reserves and to his view that "the trends didn't appear to be as we expected, which if the business doesn't change significantly you are going to assume the trends relatively remain consistent from one year to the next so that that is the expectation when you move into the audit." R.D. 135 at 466-68, R.D. 139a at 923-25, 1012-13; see D-303 at 137-38, 144-45 (audit's senior manager testifies in investigation he believes what gave he and Laccetti pause during February 2005 was "we were still struggling" with DSR). Additional analysis performed at Taro USA's request did not allay Laccetti's concerns, and the senior manager wrote to management on February 8, 2005, "The days outstanding are high and we need to consider if you are adequately reserved." Ex. D-84 at 1. Laccetti flagged DSR as an issue to the principal auditor in discussions around February 10, 2005, as reported in notes of that firm's engagement partner: "There is a growth in the number of days of credit and in the sum of the customer debts, but there is no corresponding growth in the various reserves." Ex. D-91; Ex. D-234 at 1; R.D. 139a at 1132-33; see Ex. D-86; R.D. 135 at 409-10.

Consistent with the foregoing, the Accounts Receivable Memorandum discussed the audit team's "analytical review of the Days in Receivable," followed by its "further investigation" and adjustment of the 170-day figure and comparison to 2001 and 2002, before describing five items it evaluated "to gain some more comfort with the accounts receivable balance," three of which related to the DSR adjustment. Ex. L-22 at 5-6. That memorandum provided the only discussion of the audit testing of aggregate

accounts receivable reserves that was included in the Summary Review Memorandum sent to the principal auditor. Ex. D-125 at 2-4. When, upon reviewing the latter, the principal auditor's engagement partner pressed Laccetti on whether he was completely satisfied with the existing level of reserves, Laccetti referred the partner back to the Summary Review Memorandum. Ex. D-100 at 1-2; see Exs. L-181 at 63, 65-66; D-303 at 145-46, 157, 160 (in investigative testimony, senior manager on 2004 Taro USA audit repeatedly cited Summary Review Memorandum to explain audit conclusions).

Although these memoranda we have been discussing were summaries, it is reasonable to read them as highlighting points viewed as important, and the prominence given to the DSR analysis in them is telling. In addition, subject to further consideration, of course, the mathematical calculations for the other analytical procedures had been performed and the results reviewed by Laccetti by February 8, 2005, when he wrote, "Our accounts receivable analysis is not favorable" (Ex. D-87 at 1). R.D. 135 at 414-17; R.D. 137 at 535-36; R.D. 180a at 134. But, other than perhaps a calculation of net sales as a percentage of gross sales for 2003 and 2004 (*compare* Ex. D-79 at 7 *with* Ex. L-22 at 1640), the DSR adjustment was the only new calculation. The efforts and attention that continued to be expended on the DSR analysis, at a crucial stage of the audit, with the original fieldwork completion date already past, continued uncertainty about where the audit team stood on the accounts receivable reserves, and the February 24, 2005 date on which the parent company intended to issue a press release announcing its 2004 consolidated financial results rapidly approaching (see Ex. D-88 at 2; Ex. D-34 at 2; R.D. 135 at 422-23), indicates the importance attributed to DSR in the audit. The senior manager testified in the investigation that "we struggled quite a bit with accounts receivable through the tail end of the audit" and that, ultimately, other than the testing of the individual allowances, it was the recalculation of DSR and the comparison of that figure to certain prior years that was the primary procedure that gave the senior manager comfort with Taro USA's reserves. Ex. D-303 at 92-93, 103. Even without the senior manager's perspective, the record shows the DSR procedure played an important role in the 2004 Taro USA audit.

Yet basic aspects of this DSR procedure undermined its capacity to produce supporting audit evidence. First, after discussions with Taro USA (R.D. 139a at 923-25), Laccetti "determined that \$10 million of the outstanding A/R in over 90 days relates to items that are either advance chargebacks or duplicate rebates taken by customers that take more time and effort to collect." Ex. L-22 at 5, 22. The only identifiable description of this determination in the work papers is a brief reference in the Accounts Receivable Memorandum and the Accounts Receivable Allowances Memorandum. There is no indication in these work papers or Laccetti's testimony that in making the determination he relied on anything other than management representations. The senior manager of the audit testified in the investigation that, while he recalled "some explanations as to the rebates being investigated based on the analysis we had done on the accounts receivable aging," he did not believe there was "specific audit evidence obtained" from Taro USA about advance chargebacks "that was analyzed and included

in the work papers." Ex. D-303 at 109-110. The work papers indicated that the audit team reviewed Taro USA's 2004 year-end aging report and identified nine items, five involving its three largest wholesalers, by six tick marks on a work paper. Laccetti could not recall whether or not this work related to the DSR adjustment. R.D. 137 at 491-92. But the tick marks refer only to a billback, two rebates, and "credit amounts" of unidentified type, and, apart from one billback, do not suggest that the descriptions were supported by anything more than untested management assertions. Ex. L-23 at 2129.

Second, the audit team stated that the majority of the \$10 million "related to [the company's] three largest customers," which "account for a significant percentage of [its] sales and have historically dictated payment terms, causing [its] days in receivable to be high," and that Taro USA "has a history of collecting such items." Ex. L-22 at 5-6; see Ex. L-23 at 2129 ("Since [the company] is dependent on three very large wholesalers...it is at a disadvantage when it comes to collecting payment timely. The wholesalers have historically been slow in paying [it]."). But these assertions provided no basis for distinguishing 2004 from prior years and identifying a cause that could allay the concern that the 2004 collection problem indicated a problem with the reserves.

~~Yet, third, the audit team stated it "removed these items from the [2004 DSR] calculation" and DSR "dropped] down to approximately 150 days," which "appear[s] to be in line with the historical days percentage going back to 2002 and 2001." Ex. L-22 at 5-6, 22. This omits to mention that the new calculation was based on a different formula than the 171 days and represented fourth-quarter 2004 DSR, which originally had been 164 days (*id.* at 10 (line 30, column 1)), not annual 2004 DSR. Moreover, there is no claim or evidence that the auditors even considered whether it was necessary to adjust any prior year's DSR to exclude items comparable to the \$10 million excluded for 2004. R.D. 135 at 466-68; R.D. 137 at 494-95. The audit team's point that most items on Taro USA's 2004 aging report "were in the 0-60 days category" and the \$10 million excluded in 2004 "only represented" 6% of gross receivables and 8% of net receivables (Ex. L-22 at 6) said nothing about comparability to other years. And no explanation was given for shifting the comparison to other years and avoiding any direct comparison to 2003, having chosen it as a reasonable expectation for this and other analytical procedures.~~

Even based on the 150-day recalculation, DSR had grown by more than 35% since 2003, while total accounts receivable reserves had risen by less than 2.5% and the chargebacks reserve had fallen by 87%. Ex. L-22 at 2, 5; R.D. 180 at 86 (Laccetti acknowledges that even at 150 days, the change from 2003 was "still somewhat large"). Additionally, the senior manager had called Laccetti's attention to an analysis showing that DSR continued to increase each quarter in 2004 and to a quarterly comparison of cash collections to gross sales, which was down to 34% by year-end, a low for the year, from around 45% the prior two quarters, and indicated to the senior manager that "the 4th quarter was not good" (Ex. D-82 at 1, 6). R.D. 135 at 403-08 (Laccetti); Ex. L-22 at 10, 12. The work papers also showed that "Days in receivable outstanding based on cash collections" had risen from 168.39 in 2003 to 191.48 in 2004. *Id.* at 12; R.D. 137

at 492-93. The audit team's "lag analysis," even "assuming [an] average of 110 days to collect receivables" based on 2003's much lower DSR, showed outstanding receivables that did not relate to the current quarter increasing by over \$10 million in the fourth quarter to \$48,961,234, higher than any other quarter in 2004 except the second. Ex. L-22 at 12. The team's February 8, 2005 analysis of the last five months of cash collections, post-dating the second quarter sales decline, stated that the results were "not good." Ex. D-83 at 1, 7; Ex. D-85. That analysis, not included in the work papers, showed that it would take 244.34 days to collect the year-end 2004 accounts receivable balance based on the average monthly collections for September 2004 through January 2005. Ex. D-83 at 7; Ex. D-303 at 121-26 (senior manager's investigative testimony).

Fourth, the team used incorrect DSRs for 2002 and 2001—140.26 and 148.13—that greatly overstated the real numbers—93.14 and 97.84. It is not clear why those DSRs were recalculated on a blank slate in the 2004 audit. The prior year's work papers, which both Laccetti and the senior manager stated they had consulted at some stage of the 2004 audit, and which Laccetti helped create as senior manager on the 2003 audit, contained correct DSRs back to 2001, and a 2004 audit work paper analysis of reserves and write-offs, a work step he signed off on as having reviewed, contained the correct 2002 DSR. Ex. L-110 at 44-45; Ex. L-24 at 172; Ex. D-9; R.D. 137 at 490, R.D. 139a at 882-83 (Laccetti); Exs. L-181 at 12-13, 36-37, D-303 at 110-11 (senior manager's investigative testimony). In any event, had Laccetti led a review of the audit work papers from prior years focused on whether there was a need to adjust those years' DSRs, for purposes of a valid comparison to 2004, the erroneous, off-the-cuff recalculations of the prior years' DSRs in the 2004 audit likely would not have happened.

Fifth, the audit team stated that it had averaged the DSRs for 2001, 2002, and 2003 into a "three year trended days in receivable" of 133 days and compared it to the 150 days, with the notation that "[p]art" of the difference "was a result of [the company's] accounts receivable account analyst/customer account representatives being shorthanded due to cut backs." Ex. L-22 at 6. But the average was incorrect because the DSRs for 2002 and 2001 were each 50 days too low, due to the calculation errors. There is no indication in the record of any audit testing of Taro USA's representation about staffing or how it related to collections, nor any analysis of how much of a part it might have played in increasing DSR. It did not prevent Taro USA from "process[ing] more credits during 2004 than they did in 2003" (R.D. 139a at 931); see Ex. L-175 (Sales/AR/Cash Receipts Narrative Process memorandum in work papers discussing customer service staff duties). And whatever part a staffing shortfall may have played in a 17-day difference in DSR does not explain a much larger actual difference in DSR.

Thus, contrary to Laccetti's claim that the "2004 DSR supplied evidence that Taro USA's accounts receivable reserves were adequate" (R.D. 180a at 128), the faulty DSR analysis did no such thing. Similarly, he is incorrect that it qualified as "independently develop[ing] an expectation as to the estimate by using other key factors or alternative assumptions about those factors [used to prepare the estimate]" under AU § 342.10b

and .12. Laccetti used DSR as an important test of the total accounts receivable reserves balance. He chose 2003 as his expectation for DSR, and then, after its DSR figure contrasted unfavorably with 2004, avoided any further examination of, or direct comparison with, 2003 in the analysis, and, without any reasoned explanation, casually substituted as his expectation the earlier years' DSRs or a "three year trended" average DSR. Relying on uncorroborated management representations, Laccetti adjusted the 2004 DSR figure downward without even considering making comparable adjustments to the other years' DSRs, where the stated reason for making the adjustments applied equally to the other years. This, as far as he knew, rendered the comparisons of DSRs he then proceeded to make incongruous, indeterminate, and unreliable.

b. Additional analytical procedures performed

In addition to the divisional and DSR analyses, discussed above, Laccetti's appeal briefs specify four other analytical procedures performed as substantive audit tests of Taro USA's 2004 "overall accounts receivable reserve" that, in his view, "supported the reasonableness" of that reserve. R.D. 204 at 6 n.10, 7-9; R.D. 210 at 18, 21. The role these four procedures actually played in his thinking during the audit is unclear from contemporaneous evidence. Although the calculations appear in the work papers, all of them except perhaps a calculation of net sales as a percentage of gross sales for 2003 and 2004 (see Ex. L-22 at 15, 1640) had been prepared before he wrote on February 8, 2005 to the principal auditor, and conveyed to Taro USA, that the audit team's accounts receivable analysis was not favorable. And the last three of the four are not mentioned in the audit memoranda highlighting the work performed. Laccetti testified generally that he continued to evaluate all audit data as conversations with Taro USA progressed in February 2005. R.D. 139a at 952-53. Assuming that he relied on the four analytical procedures to support his unqualified opinion on Taro USA's 2004 financial reporting package, we find that, although the procedures could have provided some information, they were too imprecise and the analysis too cursory and inconsistent with other data to provide the necessary degree of assurance, in combination with the other audit work at issue, that a potential material misstatement of Taro USA's total year-end accounts receivable reserves balance would be detected.

First, the audit team noted that, adjusting for the \$11 million excess chargebacks receivable and the \$20 million special reserve, Taro USA's year-end gross accounts receivable had risen by \$12 million, while year-end gross accounts receivable reserves had "increased only \$1 million," from 2003 to 2004. Ex. L-22 at 2-3, 5, 8, 21. The team explained the dollar amount of change in the one relative to the other as being "due to a combination of a drop in sales for 2004 (specifically the 2nd quarter), which reduced allowances booked and a slow down in payments from the largest wholesalers in 2004." *Id.* at 3. In terms of percentages, the team computed the year-end reserves as 26% of the gross in 2004, compared to 27% in 2003, *id.* at 8, from which Laccetti simply concludes that "the figures for 2003 and 2004 were closely aligned" (R.D. 204 at 9).

This first procedure thus compared the year-end gross receivables and accounts receivable reserves, in dollar amount and as a percentage of one another, for 2003 and 2004. It was a general trend analysis that did not provide any detailed study of the relationship between the year-end gross receivables and accounts receivable reserves. As to the percentage comparisons, Laccetti contends that Taro USA estimated sales allowances as a whole and chargebacks, as distinct from the other individual sales allowances, by historical comparisons of "the overall AR, gross AR to the total allowances." R.D. 180 at 38 n.15 (quoting senior manager's investigative testimony). If so, then an audit procedure making similar comparisons amounted to little more than replicating management's calculations, without testing or evaluating its methods.

Further, Taro USA's sales allowances were many and varied, as were the ways it derived the estimates for them. This first analytical procedure was a highly aggregated comparison that did not identify or provide insight into potentially significant changes in different types of allowances or explain data obtained by the audit team about particular allowances. For example, from year end 2003 to year end 2004, the rebates reserve rose by \$7.9 million to \$19.6 million, an increase of 149%, from 5% to 12% as a percentage of total accounts receivable reserves. The Accounts Receivable Allowance Memorandum had noted that "[i]n the second quarter of 2004, Taro moved from issuing rebates on a monthly basis to a quarterly basis with the exception of three customers." Ex. L-22 at 18. Evidently, this was a reversal of practice from 2003, with potentially serious implications for assessing the total reserve balance. The Summary Review Memorandum for the 2003 Taro USA audit, co-signed by Laccetti as senior manager, had explained that "during fiscal year 2003 [the company] began processing rebates on a monthly basis where in past years rebates were processed quarterly," causing "a significant reduction in the rebate allowance at December 31, 2003, which has resulted in total allowances as a percentage of accounts receivable to decline significantly at December 31, 2003 as well." Ex. D-4 at 2 (introduced without objection from Laccetti, see, e.g., R.D. 66a at 1; R.D. 141 at 1468-71; R.D. 174 at 16). Yet the first analytical procedure obscured, rather than identified or explained, any reverse dynamic in 2004, which might have misleadingly offset, through the procedure's gross comparisons of the amount or percentage of total reserves, the 87% reduction in the chargebacks reserve. And we are unable to find any analysis of this issue elsewhere in the work papers.

Additionally, there is no analysis of why the figures for 2003 and 2004 should have been "closely aligned," given the 2004 developments described in the work paper, or any attempt to reconcile this finding with the DSR analysis, in which 2003 results were discarded as a valid expectation for 2004 results. Even if 2003 were a reasonable benchmark, the explanation is flawed for why, by year end 2004, compared to 2003, the increase in the accounts receivable reserves was so small relative to the increase in the gross receivables: that the second-quarter drop in sales resulted in less sales deductions being added to the reserves, while sales allowance claims continued to arrive and reduce the reserves, and the slowdown in payments enlarged gross accounts receivable. No account is taken of the fact—noted repeatedly in the work papers and

stressed in response to comments by the principal auditor on the draft Audit Strategies Memorandum—that there was a “[r]ecover of sales in the third and fourth quarter,” once wholesalers worked off their existing inventories, resulting in a \$12 million increase in gross sales for 2004. Ex. D-72 at 3-4; Ex. L-22 at 3, 5, 12, 1638. Thus, the only reason given by the first procedure for why the rise in reserves lagged so far behind the rise in gross receivables was flawed. And Taro USA’s divisional analysis did not explain any increase at all in the reserves, much less the \$63 million increase in sales adjustments from year end 2003 to year end 2004. See *id.* at 14-15.

Second, for each successive quarter of 2004, the audit team compared the total accounts receivable reserves as a percentage of gross accounts receivable: 19%, 28%, 30%, 26%. *Id.* at 10. Laccetti asserts (R.D. 204 at 9), without explanation or citation, that this “supported the reasonableness of the overall accounts receivable reserve.”

Again, this was a broad, highly aggregated comparison. The rising percentages over the course of the year until the fourth quarter and the decline that quarter to around the second-quarter level, still close to the third quarter level and well above the first, is not consistent with the description of 2004 developments provided in the first procedure. This casts even further doubt on the validity of those descriptions or on the value of the broad comparisons of total balances of accounts receivable reserves and receivables. Moreover, if Laccetti is suggesting that the quarterly procedure shows consistency of the reserves from quarter to quarter, Taro USA used the same methodology throughout 2004, according to Laccetti (see Ex. D-72 at 5), so the reserves could have been consistently incorrect. Also, Laccetti wrote in his March 3, 2005 email to the principal auditor that “I believe we did receive some information [from Taro USA] late in the audit process,” and “[t]hey do book allowances through-out the year,” but “they have no real basis for the amounts they record.” Ex. D-117 at 1. There is no indication this problem would have been remedied as to accounts receivable allowances as a whole and chargebacks, for which no detailed calculations were provided during the audit. Under these circumstances, the sequence of quarterly reserve percentages is unrevealing.

Third, splitting gross sales in two different ways, Laccetti compared net sales as a percentage of gross sales for 2003 and 2004—51% and 43%—with cash collections as a percentage of gross sales for those years—43% and 40%. Ex. L-22 at 15, 1640. Explaining that the more closely net sales approximate cash collections, the more exact is a company’s accounting estimation of the amount of cash it will realize from its sales, Laccetti testified that he “took comfort” from the fact that “the gap” between the percentage of gross sales comprised by net sales and the percentage of gross sales comprised by cash collections “was closing” from 8% (51% minus 43%) in 2003 to 3% (43% minus 40%) in 2004. R.D. 139a at 930. In a related calculation, the team looked at the relationships from the other side of the coin. The part of gross sales not comprised by net sales is sales adjustments, and the part of gross sales not comprised by cash collections is uncollected gross sales. Dividing these other components of gross sales by total gross sales, the team calculated an “Allowance percentage based

on net sales” and an “Allowance percentage based on cash collections,” showing that sales adjustments had risen from 2003 to 2004 by a greater percentage (49% to 57%) than uncollected gross sales had risen (57% to 60%), as a percentage of gross sales. Ex. L-22 at 15. The work paper stated that “the allowance percentage for net sales and cash collections increased” due to “price erosion in 2004” and that cash collections were down “due to decrease in net sales in 2004 and slow down in payments from three largest wholesalers.” A tick mark linked the figures showing the decrease in net sales as a percentage of gross sales from 2003 to 2004 to the statement, “Due to decrease in second quarter sales in 2004 and price erosion on generic drugs in 2004.” *Id.*

Although, in concept, such an analysis could be useful, this third procedure did not determine with any precision the extent to which net sales related to collections on receivables. As Laccetti noted, Taro USA did not supply an analysis of cash collections as a percentage of gross receivables or lag reports for subsequent cash receipts or for accounts receivable allowances. Ex. D-100 at 1; R.D. 135 at 314, 372. The lack of such analysis and reports indicates that the cash collection balances could tell the auditors when cash was collected but not when the related sales took place and not whether all sales allowances had been claimed on the sales. Yet the third procedure’s evaluation of the “gap” between net sales and collections stopped at comparing the percentage gap year over year. No effort was made to understand the components of the gap and the reason for the change between periods. See AU § 329.18 (“More effective identification of factors that significantly affect the relationship is generally needed as the desired level of assurance from analytical procedures increases.”).

Indeed, the third procedure’s focus on comparing the gap between two sets of percentages in 2003 with the gap between them in 2004, failed to address the changes from 2003 to 2004 in components of each set of percentages—sales adjustments, net sales, and cash collections—even assuming, contrary to the DSR analysis, that 2003 was a reasonable expectation. Specifically, it failed to address the 8% increase in sales adjustments as a percentage of gross sales, compared to only a 3% increase in uncollected gross sales as a percentage of gross sales, from 2003 to 2004; the \$7.7 million drop in cash collections, \$35 million drop in net sales, and \$63 million jump in sales adjustments, on a \$28 million increase in gross sales, from 2003 to 2004; and the nearly \$16 million drop in cash collections from the third to the fourth quarters of 2004, on only about a \$1 million decrease in sales (Ex. L-22 at 2-3, 8, 10, 15, 1640). Although a work paper for the third procedure, certain other work papers, and Laccetti’s testimony purport to discuss this, the explanations raise serious questions and concerns.

The audit team stated that the drop in 2004 net sales was “primarily due to the big decrease in sales in the second quarter of 2004” (Ex. L-22 at 5), which, as noted, did not address the recovery of sales in the rest of 2004. A work paper for the third procedure attributed the drop in net sales only partly to “price erosion on generic drugs in 2004.” Ex. L-22 at 15. The Summary Review Memorandum for the second quarter 2004 review, co-signed by Laccetti, newly promoted from senior manager to partner

under the engagement partner, had stated: "We reviewed the sales by product for the second quarter of 2004 compared to the first quarter, noting that the decrease in sales was a result of both price erosion and a decrease in quantities sold... Even if generic trends remain low, the new branded products [the selling rights to which Taro USA acquired in July 2004] will increase sales in the second half of 2004." Ex. L-108 at 1.

In attempting to explain why Taro USA's net sales fell by \$35 million, while its overall gross sales grew by \$28 million, from year end 2003 to year end 2004 (Ex. D-63 at 59-62; Ex. L-22 at 8-11), Laccetti testified that "net sales is a result of processing additional allowances... if the three wholesalers were working to reduce their inventory through the channel, and additional allowances were being presented to" Taro USA, this would "reduc[e] the net sales number." R.D. 135 at 453-55. But that claim is not grounded in the record. Laccetti understood that Taro USA established revenue reductions for estimated sales allowances "at the time of sale." Ex. D-63 at 5. Indeed, the parent company publicly reported for 2003 and 2004 that, "[w]hen we recognize and record revenue from the sale of our pharmaceutical products, we simultaneously record an estimate of various future costs related to the sale," including "our estimates of product returns, rebates, chargebacks and other sales allowances." Ex. J-1 at 47; Ex. J-17 at 44. Such estimates offset both gross sales and gross receivables. According to Laccetti, "Once a sales adjustment is submitted to Taro US by the customer and processed, the estimated accrual is removed from accounts receivable allowances on the balance sheet" and "for the purposes of the income statement, the estimated sales adjustment recorded is adjusted to reflect the actual processed credit amount," so that the combination of the remaining estimated amounts, "along with actual credits, reduced gross sale[s]." R.D. 135 at 208-09; R.D. 180 at 10. Laccetti does not argue that Taro USA offered more sales allowances in 2004 than 2003; in fact, he claims the higher branded sales reduced sales allowance reserves in 2004 (R.D. 204 at 10 & n.13), and the work papers stress the halving or discontinuation of a discount that caused sales to "decrease[] dramatically in the second quarter" (Ex. J-29 at 7). Thus, the only apparent ways that "processing of additional allowances" could "reduc[e] the net sales number" would be if the actual sales allowance claims approved in 2004 were higher than the corresponding estimated sales adjustments recorded for them at the time of sale or if those approved claims were based on prior-year sales. This suggests either that the 2004 estimates were too low or that the sales adjustments for 2004 were being depleted by sales allowance claims based on sales from a prior year. Either way, if Laccetti "took comfort" in this, he lacked a basis in the third procedure for doing so.

Fourth, the audit team again looked at cash collections and net sales. This time, the team calculated a two-year, 2003-2004 average of cash collections divided by gross sales, rendered that figure as a percentage (41.66%) and multiplied it by 2004 gross sales (\$580 million), yielding a dollar expectation for 2004 net sales (\$241.7 million) that the team then compared to actual 2004 net sales (\$248 million). Ex. L-22 at 1640 (work paper containing the calculations, without elaboration). Laccetti testified that the \$6.3 million difference between the actual and expected net sales was "in the reasonable

range," "from an estimation perspective," because he knew that Taro USA "processed more credits during 2004 than they did in 2003," and thus the procedure "gave us comfort that they were doing a good job estimating allowances." R.D. 139a at 931.

No explanation is given for why an average of 2003 and 2004 results is the basis for a reasonable expectation for 2004 results here, whereas 2003 results are used in other analytical procedures and are rejected as a basis for direct comparison or averaging with 2004 in the DSR procedure. The "Average cash collections %" and \$6.3 million difference therefore appear to be arbitrary choices. Nor does Laccetti provide any reference point or analysis in declaring them to be "in the reasonable range."

This fourth procedure does no better job than the third of explaining the large decrease in net sales from 2003 to 2004. Laccetti's reason for deeming the results reasonable here is the same unsupported view just discussed that lower than expected net sales can be explained by Taro USA "process[ing] more credits during 2004 than they did in 2003." If by this he means that net sales could drop in 2004 because Taro USA processed more of the total sales allowance claims it would receive that year based on that year's sales than it had done in 2003, then that, too, is inconsistent with the record. Regardless of whether Taro USA processed a sales allowance claim in the same year as the sale giving rise to it, the company made a sales adjustment for that claim at the time of sale that would stand in for that claim until it was received and processed. Net sales would be unaffected by when the claim was actually processed, so long as the estimate matched the claim. If it did not, then that could indicate a problem with the sales adjustments and related reserves. Thus, the fourth procedure did not show that Taro USA was "doing a good job estimating allowances."

The same is true of two additional analytical procedures Laccetti cited before the hearing officer as tests of Taro USA's 2004 accounts receivable allowances as a whole: (1) a calculation of year-end net accounts receivable as a percentage of net sales for 2001 through 2004 (41%, 50%, 40%, 50%); and (2) a "lag analysis," which, "assuming average of 110 days to collect receivables," showed "Prior net A/R still open" at the end of each successive quarter of 2004 (\$41,220,640, \$67,745,445, \$38,939,962, \$48,961,234). R.D. 180 at 75, citing Ex. L-22 at 8, 12.

No work paper, testimony, or argument in this case explains how, if at all, the first of these two additional procedures supported the reasonableness of the sales allowance estimates. The broad comparisons do not isolate the sales allowances or movements within them or identify circumstances that might explain the percentages. They are related to the original DSR calculations, which raised, not allayed, concerns.

As to the lag analysis, the record indicates it was not designed to be predictive of the year-end reserves balance but served a more general purpose. Laccetti testified that he was concerned that falling cash collections could indicate a problem with the reserves. R.D. 135 at 409-10, 466-68; R.D. 139a at 923-24. He further testified that he

believed that the purpose of the lag analysis was "to show that there was a slowdown in cash payments" to Taro USA, consistent with a note at the top of the work paper stating, "Per management slow down in cash collections is due to delays in payments made by three major wholesalers that account for over 60% of Taro USA's business." R.D. 135 at 387-88. Even if, as the senior manager testified in the investigation, the purpose was "just to get a sense of what could be the potential net AR that was still out there" at year-end 2004 from prior periods (Ex. D-303 at 116), the analysis was very imprecise. As noted, Taro USA did not provide any analysis matching cash collections or accounts receivable allowances to sales. The broad assumption in the lag analysis of "average of 110 days to collect receivables" was based on 2003 DSR, which Laccetti rejected as an expectation for 2004, not the much higher 2004 DSR figures of 170.84 days (unadjusted) or 150 days (adjusted), or the even higher cash-collection based calculations of 191.48 days for 2004 or 244.34 days for September 2004 to January 2005. To the extent the lag analysis showed a slowdown in cash collections in 2004, it did not indicate the cause or examine any prior period. As to the cause, it appears from the work paper that Laccetti simply accepted management's representation.

In conclusion, for the reasons discussed, the analytical procedures that Laccetti has cited in addition to the DSR analysis provided little or no substantive evidence of the reasonableness of Taro USA's 2004 year-end total reserves balance.^{18/}

3. Confirmations testing and alternative procedures

The Accounts Receivable Memorandum discusses the confirmations work, identifying it, after discussing the DSR analysis, as one of five items that the audit team evaluated to "gain some more comfort with the accounts receivable balance" and as providing "additional comfort that the client is able to collect on the outstanding receivables." Ex. L-22 at 6. According to the work papers, "[t]o determine that receivables in A/R Aging at 10/31/04 exist and are correctly valued," the audit team randomly selected 130 open invoices, totaling \$73 million, from the aging report, each representing "the actual invoice that was submitted to the customer," and sent confirmation requests to the customer. Of these invoices, 25%, totaling about \$19 million, were "undisputedly confirmed," and "we traced almost 75% of the remaining receivables," "for which confirmations were not received (or \$54 million)," "to subsequent collections"; the result was that "[o]nly \$2,000 of the selection made could not be verified," representing the sum of the only amounts not confirmed by customers

^{18/} We do not decide whether, as the Division contends and Laccetti hotly contests (R.D. 205 at 6-7, 24; R.D. 210 at 9-10; R.D. 215 at 7), AU § 329 affirmatively required him to calculate and/or compare certain ratios, which were planned for the 2004 Taro USA audit or appear in the work papers for that audit, of sales adjustments to gross sales, on the one hand, and year-end accounts receivable reserves to gross accounts receivable, on the other (or variants of those ratios specific to chargebacks).

who had responded to the confirmation requests. *Id.* at 6, 1625-36; Ex. L-110 at 42; Ex. L-174; see Ex. D-63 at 8 (Revenue Recognition Memorandum). Based on the confirmations received and the alternative procedures performed, the team concluded that the year-end 2004 gross accounts receivable balance ("Trade A/R balance") was "without material misstatement." Ex. L-22 at 1628.

Nothing in the work papers or testimony specifies how this testing of gross accounts receivable would have addressed the accounts receivable reserves. Laccetti does not claim this procedure helped to verify or explain a slowdown in cash collections in 2004 asserted by Taro USA and of concern to him during the audit. He testified that the procedure was meant "to determine that the invoices that [the company] issued were real," that is, "to confirm that the invoice amounts that [it] had recorded [on the aging report] were in agreement with the client's records." R.D. 137 at 850; R.D. 139a at 918. The selections were limited to open invoices as of October 31, 2004 and did not include any open credits or open deductions, which in Taro USA's accounting system encompassed approved, pending, or unapproved sales allowance claims. Ex. L-22 at 1625; L-174; R.D. 135 at 459-60. Less than the full amount of an invoice might be paid due to a sales allowance claimed by the customer arising from that or some other transaction, and this would have implications for the relevant reserve. But there is no evidence that this procedure involved confirming with the customer (see R.D. 144 at 2631-32) (Laccetti's expert) or otherwise testing the validity of such a claim, much less testing whether it was properly covered by or discharged from the appropriate reserve.

Furthermore, even if this procedure had involved evaluation of the validity of sales allowances claims or checking them against accounts receivable reserves, there were serious limitations to its usefulness in assessing the adequacy of the reserves. If some of the amount billed on a selected invoice were offset by a chargebacks claim, Laccetti would not have been able to obtain comfort about the estimation of the reserve by tracing that chargeback to a particular sales deduction corresponding to it in the reserve, given his acquiescence in Taro USA's view that it was too difficult to identify and keep track of chargebacks by the transactions that had given rise to them, to provide an analysis of the lag between sales and sales allowance claims arising from them, and to make a detailed calculation or specific estimate for chargebacks. If all the testing did was essentially check consistency of Taro USA's accounts receivable collections with its bad debts reserve, then the testing would not have been directed at whether Taro USA reasonably estimated the reserves for the specific sales allowances. Comfort about the collectability of the full amount currently owed on invoices is not the same as comfort about the amounts that ultimately will be realized on the sales, once all sales allowances claims arising from those transactions that will validly be made have been satisfied. For these reasons, there is no evidence that the confirmations testing and alternative procedures would have significantly supported the part of the year-end 2004 accounts receivable reserves balance not already individually tested.

4. Audit analysis of certain items on the year-end aging report

On February 8, 2005, Laccetti had noted he was "now asking for account level detailed analysis from the Company to support [Taro USA's] position" that "the accounts receivable are fairly stated as currently presented." Ex. D-87 at 1. The audit team selected certain items from Taro USA's year-end accounts receivable aging report and asked the company to "provide us with some analysis to support that you are adequately reserved." Ex. D-82 at 1; Ex. D-84 at 1; Ex. D-85; Ex. D-86 at 1. It was this audit work to which the Summary Review Memorandum referred when stating that, due to the deficiency in Taro USA's estimation process, "we expanded our procedures to perform detailed substantive tests of individual accounts receivable to gain comfort that the amounts were properly recorded at net realizable value." Ex. D-125 at 4; R.D. 135 at 414-17; R.D. 137 at 535-36. Laccetti testified that, in response to his concerns about the 2004 cash collections, management had represented that Taro USA's major wholesalers "were not paying on terms, they were kind of stringing them out, and Taro had little leverage to put pressure on them." R.D. 139a at 923-25. He further testified that the "account level detailed analysis" consisted of "validat[ing] a little bit more" about "some of these older aged accounts related to the wholesalers," through "obtaining account-level information," and "represent[ed] additional procedures that we performed to understand the detail." R.D. 137 at 491-92; R.D. 139a at 927, 952-53.

On a work paper entitled "AR Aging 12-31-04," consisting of spread sheets with 36,875 line items of Taro USA's year-end receivables, the audit team placed one of six tick marks next to nine of those items, totaling \$12,158,275. The selected items, an open invoice and eight open debits, were all listed on the aging report as unpaid for longer than 90 days. In five cases, the customer was one of Taro USA's three largest wholesalers, and, in the other four, one major drugstore chain. The end of the work paper provided descriptions for five of the six tick marks, reporting information from Taro USA; the sixth, placed beside the largest of the nine items, a \$3.2 million open debit for one of the three wholesalers, was left blank. Ex. L-23 at 1214-1215, 2129. As to the wholesaler items for which the tick marks provided information, the descriptions stated that payment of the \$802,429 open invoice was expected based on the customer's payment history; that a \$792,449 billback inadvertently taken twice was being actively pursued by Taro USA; that a \$594,810 rebate claim for which the customer was not eligible had been denied and Taro USA was confident based on past practice it would be withdrawn; and that a \$2,778,876 rebate deduction had been "fully reserved for and is part of the existing reserve against A/R." The tick mark describing the other four items stated that they were "offset by credit amounts on the aging report," except for \$131,000 that would be offset against the chain's next payment. Ex. L-23 at 2129; see Ex. R-12 at 2 (Taro USA management representation letter to Ernst & Young, dated February 18, 2005, stating, "Receivables classified as current includes an amount of approximately \$792,000 relating to rebates inadvertently taken by a Wholesaler, which is fully collectible and we should expect to collect within the next year."). A concluding note under the tick marks stated Taro USA was "dependent on three very large

wholesalers,” who “have historically been slow in paying” and have put the company “at a disadvantage when it comes to collecting payment timely,” but that management “is confident that the above items identified are fully collectible.” Ex. L-23 at 2129.

Although this procedure did involve considering the validity of particular sales allowance claims and checking a sales allowance claim against a reserve, there is no evidence it provided any significant support for the part of the year-end 2004 reserves balance not already subjected to detailed individual testing. Laccetti’s description of the procedure in terms of gathering modest incremental information, the lack of clearly expressed criteria and formality to the selection, and the relatively small number of items chosen all indicate that the scope and objectives of the procedure were very limited. Laccetti does not claim that this was a statistical or nonstatistical sample that would have allowed him to extrapolate the results of the direct testing to the larger population (see AU § 350). Nor do the work papers or testimony describe any risk assessment on which the choices might have been based. The audit team selected a small number of individually large, older receivables, some consisting of certain types of sales allowance claims. But there is no evidence that the selections reflected the total amount of each type of sales allowance claim in that age category on the aging report, much less represented the receivables on the overall aging report, taking into account, for example, whether certain types of allowances might be claimed in relatively small numbers of larger amounts and others in relatively large numbers of smaller amounts.

The only sales allowance claims referred to in the tick marks are a billback, two rebates, and unevaluated “credit amounts” of unidentified type. This procedure was subject to the same limitations identified in the concluding paragraph of our discussion of the confirmations work. Focusing on the aging of some open accounts receivable is not systematically analyzing the credit claims received, those processed, and those rejected by Taro USA in 2004 with a view to assessing its estimation of its year-end reserves. And apart from the billback entry, stating that Taro USA has shared “email correspondence with [Ernst & Young] relating to [the company’s] claim” that it was actively pursuing payment, nothing in the descriptions indicated they were supported by more than untested management assertions. Indeed, one tick mark, for the \$594,810 rebate, was stated in the first person from Taro USA’s point of view: “[Due to wholesaler’s ineligibility for claimed rebate] we have denied this claim and requested payback. We are confident in having this deduction removed by [the customer] as they have been cooperative in the past with items like this.” Ex. L-23 at 2129.^{19/}

^{19/} Before the hearing officer, Laccetti claimed to have relied on two additional procedures as tests of accounts receivable allowances as a whole: (1) “randomly select[ing] three months and test[ing] the reconciliation of accounts receivable to the general ledger in order to gain comfort that the underlying accounts receivable ledger reconciles to the general ledger”; and (2) obtaining a written representation from management that “adequate provision had been made for losses, costs, and expenses

C. Summary of Findings of Violation

Based on the foregoing analysis, the Board finds that the Division proved by a preponderance of the evidence that Laccetti, acting as the auditor with final responsibility for the 2004 Taro USA audit, violated PCAOB Rules 3100 and 3200T. He did so by failing to comply with numerous PCAOB auditing standards in his work on Taro USA's 2004 sales allowance reserves as a whole.

The Division proved that Laccetti had an understanding of Taro USA's process for estimating accounts receivable allowances as a whole and chargebacks that heightened the rigor required of the overall audit work on the total balance. The Division proved that the combination of procedures Laccetti used to assess the accounts receivable allowances as a whole did not, in many respects, comply with PCAOB auditing standards and was insufficient to provide reasonable assurance that Taro USA's 2004 financial reporting package was free of material misstatement. In particular, the audit work on Taro USA's individual 2004 sales allowance reserves other than chargebacks did not contribute significantly to evaluation of the rest of Taro USA's total 2004 reserves balance; the comparison of the year-end 2003 and 2004 chargebacks reserve balances and the days sales in accounts receivable analysis undermined, rather than supported, the reasonableness of the total balance; the other analytical procedures were too general to provide the high level of assurance sought from them; and the review and testing of the 2004 interim and year-end aging reports was too limited to yield the necessary additional support for the total reserves balance.

The Division further proved that, in assessing the total balance, Laccetti repeatedly relied on untested management representations, such as in the DSR analysis and in the procedures on Taro USA's year-end 2004 aging report, and that he uncritically accepted an insupportable management representation about the steep drop in the year-end chargebacks reserve from 2003 to 2004. The representation about the change in the chargebacks reserve over that period did not explain the magnitude of the change or a valid reason for the change, was based on a calculation Laccetti claims to have believed was "crude and unsuitable for use in connection with the issues of accounts receivable estimations and revenue recognition," and was contrary to the

that may be incurred subsequent to 12/31/04 in respect to sales made prior to that date." R.D. 180 at 49 (citing Ex. L-110 at 32-33), 76 (citing Ex. R-12 at 2); R.D. 180a at 84. But neither of these basic procedures—the first of which concerned the general reliability of data in the accounts receivable ledger, not specifically the reasonableness of the level of accounts receivable reserves, and the second of which is "not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion," AU § 333.02—could compensate for the insufficiency of the combination of other procedures used by Laccetti to test accounts receivable allowances as a whole.

contemporaneous increases in gross sales, processed chargebacks, gross receivables, other major sales allowance reserves, and total sales allowance reserves.

Additionally, the Division proved that Laccetti did not do enough to address numerous factors that called into question Taro USA's ability to reasonably estimate accounts receivable allowances and that indicated heightened risk surrounding the adequacy of those allowances that demanded that he apply greater audit scrutiny. Such information included management's asserted lack of inventory data from wholesalers, lack of any detailed calculation or explanation for its estimation of accounts receivable allowances as a whole or chargebacks, lack of ability to match chargebacks to the sales that gave rise to them, and lack of any determination of the lag time between the sales and the claims, as well as the substantial, unexplained increase in the number of days Taro USA's sales were going uncollected in 2004. Despite claiming to have expanded the audit procedures and audited around a process deficiency, Laccetti did not employ any effective additional or alternative procedures.

Accordingly, we find that Laccetti, in his audit work on Taro USA's year-end 2004 accounts receivable allowances as a whole, (1) violated AU §§ 150 and 230 by failing to exercise due professional care, which requires observing the standards of field work, "diligently perform[ing]" the "gathering and objective evaluation of evidence," and exercising professional skepticism, "an attitude that includes a questioning mind and a critical assessment of the audit evidence," according to which the auditor "should not be satisfied with less than persuasive evidence because of a belief that management is honest"; (2) violated AU §§ 150 and 326 by failing to be "thorough" in his "search for evidential matter" and "unbiased in its evaluation," to "consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions" in the financial reporting package, and to obtain sufficient competent evidential matter to provide a reasonable basis for forming an audit opinion; and (3) violated AU § 342 by failing to evaluate the reasonableness of a significant accounting estimate. We further find that, by not adequately evaluating the contrary audit evidence, Laccetti failed in his assessment of whether Taro USA was able to reasonably estimate accounts receivable allowances as a whole and therefore did not perform audit procedures sufficient to evaluate Taro USA's compliance with GAAP, in violation of AU §§ 150, 230, and 326.

In addition, we find that Laccetti violated AU § 333 by accepting management's explanation for the dramatic decrease in the chargebacks reserve, despite audit evidence contradicting that representation, without meaningfully investigating the circumstances. We also find that, in conducting the DSR analysis, Laccetti failed to comply with numerous provisions of AU § 329: § 329.21, which provides that the auditor "should evaluate significant unexpected differences," and, lacking an explanation, "should obtain sufficient appropriate audit evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a likely misstatement"; § 329.17, providing that the expectation should be precise enough to provide the desired level of assurance that differences that may be potential material

misstatements would be identified; § 329.20, providing that the amount of the difference from expectation that can be accepted without further investigation should be consistent with the level of assurance desired; § 329.18, stating, "More effective identification of factors that significantly affect the relationship is generally needed as the desired level of assurance from analytical procedures increases."; § 329.14, stating, "As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation."; and § 329.13, stating, "It is important for the auditor to understand the reasons that make relationships plausible...."

The initial decision found that the Division proved by a preponderance of the evidence that Laccetti violated PCAOB Rules 3100 and 3200T and AU § 316.64 due to the lack of a retrospective review of Taro USA's 2004 accounts receivable allowances. I.D. 75-77. Only sanctions issues are raised on review with respect to that violation.

Finally, we do not find a violation of AU § 560 or of AU § 561.^{20/}

^{20/} The Division argues that Laccetti violated AU § 560 because, during his work on the 2004 audit, he obtained information about sales allowance claims processed by Taro USA after the balance sheet date but did not evaluate them to the extent planned or, in the case of chargebacks, at all, to assess the adequacy of the corresponding year-end reserves. R.D. 205 at 6, 18-19; R.D. 215 at 8; R.D. 168 at 128-30; R.D. 182 at 29-30, 40-43. Laccetti disputes the Division's interpretation of the work papers and the applicability of AU § 560. R.D. 210 at 11-12; R.D. 180a at 230-37. Under the plain language of the standard, processed sales allowance claims could be a type of subsequent "event[] or transaction[]" that could "provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements" and therefore could require "evaluation by the independent auditor." See AU §§ 560.02, .03; see also AU § 560.04 (identifying events of this type "calls for the exercise of judgment and knowledge of the facts and circumstances"). But even assuming that such an evaluation were required here, the Division did not prove that Laccetti failed adequately to evaluate subsequent processed credit claims corresponding to those accounts receivable reserves that were assessed individually in the audit, and we do not reach the issue of whether PCAOB standards required that Taro USA's chargebacks estimate be assessed individually, rather than through accounts receivable reserves as a whole.

The Division argues that Laccetti violated AU § 561 (and relatedly AU § 333) because he did not "consider the effects on his audit report" of statements in a mid-2005 letter to SEC staff by Taro USA's parent company that "we monitor inventory in the channels based" on certain factors, allowing it to "reasonably estimate the level of inventory in the distribution channels and properly recognize revenue" (Ex. D-294 at 6). R.D. 205 at 19. According to the Division (*id.* at 22-23), these statements contradicted statements made by the parent company in a December 17, 2004 letter to SEC staff

VI.

A. The Division's Challenge to the Hearing Officer's Exclusion of Certain Post-Audit Evidence

The Division argues in its appeal briefs that the hearing officer erred by excluding 11 proposed hearing exhibits, including excerpts from a transcript of investigative testimony, "that, if admitted, should have affected the liability and sanctions determinations." R.D. 205 at 26. Laccetti disagrees. R.D. 210 at 15-17. We discuss the issue of the admissibility of the 11 proposed exhibits because it has been properly raised on appeal and to provide guidance to PCAOB hearing officers, but the issue does not affect our review of this case.

The excluded exhibits were created after the 2004 audits of Taro USA and its parent company. These exhibits fall into three general categories: (1) excerpts of the February 27, 2008 investigative testimony of an Ernst & Young national office partner who coordinated a review of the 2004 Taro USA audit, in response to questions from SEC staff to the parent company about its Form 20-F, and two documents related to that partner's review (proposed Exs. D-306, D-171, D-213); (2) documents prepared in 2006 that, according to the Division, show that Laccetti contended, in urging additional audit procedures for the 2005 Taro USA audit, that there were inconsistencies, pertinent to Taro USA's accounts receivable allowances, between the parent company's responses to the November 24, 2004 and March 24, 2005 SEC staff comment letters, supporting the Division's argument that he should have investigated the discrepancies earlier (proposed Exs. D-174, D-177, D-185, L-134); and (3) a December 29, 2005 SEC staff comment letter to the parent company and versions of an outline that Laccetti helped prepare in response that, the Division argues, contain inaccurate statements about procedures performed during the 2004 Taro USA audit (proposed Exs. D-163, D-161, D-170, D-183).

PCAOB Rule 5441 states that the hearing officer "may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious." As

that "[w]e have no way of knowing or reasonably estimating (i) the actual levels of inventory in our distribution channels or (ii) the then-current inventory policies, or desired inventory levels, of our distributors" (Ex. D-44 at 3). Laccetti argues that the statements in the second letter clarified, rather than contradicted, the statements in the first and suggests that "the time frame requirements of AU § 561" may not apply to the period of the second letter, which postdated the Taro USA audit report for 2004 and preceded the issuance of the principal auditor's audit report and the parent company's 2004 consolidated financial statements. R.D. 210 at 12-14 & n.10. We have thoroughly discussed Laccetti's understanding of Taro USA's estimation of sales allowances based on detailed other evidence, and need not, and do not, rely on the alleged contradiction in the letters or resolve these charges that are grounded entirely in such a contradiction.

the Board noted in adopting the rule, "Rule 5441 is not intended to limit a hearing officer's authority to exclude or allow evidence based on reasonable principles of admissibility, but is intended to allow a hearing officer reasonable flexibility," affording the hearing officer "discretion to resolve evidentiary issues." PCAOB Release No. 2003-015 at A2-113 (Sept. 29, 2003). Rule 5424 provides that, in connection with any hearing ordered by the Board, "a party may request the issuance of an accounting board demand of a registered public accounting firm or an associated person of such a firm, or an accounting board request of any other person" and "upon application of any party or on its own initiative, the Board may seek issuance by the Commission of a subpoena to any person...requiring the person to provide any testimony or produce any documents that the Board considers relevant or material to a Board proceeding." And Rule 5426 identifies five circumstances in which a motion to introduce a prior sworn statement of a nonparty witness in lieu of live testimony "may be granted" by the hearing officer, including that "the party offering the prior sworn statement has been unable to procure the attendance of the witness by accounting board demand" (here, the hearing officer denied the Division's request for issuance of such a demand to the Ernst & Young national office partner because he had retired, R.D. 157 at 7) and that, "in the discretion of the hearing officer "it would be desirable, in the interests of justice, to allow the prior sworn statement to be used"; "In making this determination, due regard shall be given to the presumption that witnesses will testify orally in an open hearing."

Preliminarily, we note that the hearing officer's explanations for excluding from evidence materials in the first and second categories would appear to fall within the reasonable flexibility afforded by Rule 5441 for resolving evidentiary issues. In ruling the national office partner's testimony inadmissible, for example, the hearing officer observed that it "sets forth his impressions and conclusions formed in 2006, long after the 2004 audit was concluded" and pointed out the difficulty of "assess[ing] what, if any weight, should be ascribed to the testimony in evaluating whether Laccetti complied with PCAOB auditing standards in conducting the 2004 Taro [USA] audit," given that the testimony "consists of broadly stated and somewhat ambiguous impressions and conclusions formulated in 2006 coupled with the fact that [the partner] did not testify at the hearing." R.D. 157 at 4, 8-9. In excluding the second set of exhibits—those offered solely for alleged inconsistencies between the parent company's responses to SEC staff letters (see R.D. 205 at 23 n.13, 28)—the hearing officer stated that any probative value they might have was minimal compared to "the documents [in the record] that were created during the course of the 2004 audit," yet would require inquiry into "collateral events in 2006," in that the exhibits, from 2006, mostly referred to inconsistencies between letters to SEC staff and company representations to Ernst & Young during the 2004 audit, without specifying the inconsistencies or the representations, and contained a clear indication that the perception of inconsistencies referred to in 2006 was shaped by information acquired after the 2004 audit (see Ex. D-185 at 2). R.D. 157 at 13-14.

On the other hand, the hearing officer's stated grounds for excluding the third category of exhibits appear to be inadequate or incorrect. These exhibits include

statements prepared for the Ernst & Young national office partner and Taro USA's parent company's principal auditor, in response to a December 29, 2005 SEC staff letter to the parent company asking it to "have your auditors explain to us how they became satisfied that the balance of accrued returns and price adjustments at December 31, 2003 and 2004 were fairly stated" (Ex. D-163 at 3). The exhibits purport to list procedures used in the 2004 Taro USA audit by the very auditors who performed or supervised them—Laccetti and the senior manager—that the Division argues were not done. After an extended colloquy among counsel, upon objection at the hearing to the Division's use of one of the exhibits as foundation for further questioning of Laccetti about the exhibits, the hearing officer stated, "I don't see any basis for excluding Mr. Laccetti's statements here. I think there may be circumstances that affect the weight that can be given to them, but I haven't heard anything that suggests anything be excluded." R.D. 137 at 565-76. The Division's questioning of Laccetti on Ex. D-163 proceeded, and then moved on to Ex. D-161 and similar exhibits (not briefed here).

But when the Division asked Laccetti if his statement in one of the exhibits was inaccurate, the hearing officer interrupted and would not allow further questioning in that line, stating: "It sounds like you're trying ... to prove that [Laccetti] was not candid in comments he was offering back, but that's not a part of the charges in this case."; "No, I'm not going to hear that [that the exhibit is relevant to sanctions]"; and "No, you're not going there. I said you could go ahead on the theory that you were offering statements that he made as admissions relating to what, in fact, had been done[,] [not]...going off on a cross-examination on communications that are sort of extrinsic to this case." R.D. 137 at 586-88. When the Division made an offer of proof on the other two exhibits (Exs. D-170 and D-183), the hearing officer reiterated his view that the exhibits "don't relate to the charges in the OIP. Then you would be going, well, let's prove something else in an audit in 2007. ... No. It's got to relate to the circumstances in the OIP." *Id.* at 608-09.

When, after the hearing, the Division moved for admission of the third group of exhibits on the additional ground that they were relevant to Laccetti's "understanding of what should have been done during that audit and [knowledge] he had made a mistake in completing the audit," the hearing officer denied the motion. The order reasoned that:

The issues in this case relate to whether Laccetti violated PCAOB auditing standards in certain respects during the 2004 Taro [USA] audit. Even if the Division's contention that the outlines included "false and/or misleading statements" regarding the 2004 audit were accepted, those statements were offered in 2006, long after the 2004 audit was concluded. Laccetti's state of mind in 2006 is irrelevant to any reasoned judgment of his state of mind during the 2004 audit. Moreover, the Division's characterizations of the statements in the various outline drafts are unquestionably subject to dispute. To properly evaluate the statements it would be necessary to reconvene the hearing in order to conduct an inquiry into the context in which the statements were made in 2006. Such

an inquiry into events remote in time and circumstance in order to clarify the meaning of statements that would be entitled to no significant weight in any event would be entirely unjustified.

R.D. 157 at 12. The order later reiterated that “to properly evaluate the statements in these documents, it would be necessary to reconvene the hearing in order to embark on a possibly extensive inquiry into completely collateral events in 2006.” *Id.* at 14.

In light of the hearing officer’s stated reasons for excluding the third group of exhibits, we discuss the issue to avoid any misunderstanding about use of post-audit evidence. It is well recognized that evidence showing that a person gave false or misleading accounts of his or her conduct to investigators or others can be probative of the occurrence of underlying misconduct.^{21/} Moreover, evidence of misrepresentations made in response to questions about possible misconduct can also be, and often is, relevant to determining the appropriate sanction. The SEC commonly considers deceptive conduct committed after the charged violation as support for imposing its own sanctions.^{22/} And the sanctions guidelines of at least one securities industry self-regulatory organization specifically direct its adjudicators to deem it an aggravating factor when a respondent attempts to conceal his or her misconduct or mislead regulators or his or her own firm.^{23/} Notably, Laccetti himself contends it is relevant to

^{21/} See, e.g., *SEC v. Sargent*, 229 F.3d 68, 78 (1st Cir. 2000); *SEC v. Musella*, 748 F. Supp. 1028, 1040 (S.D.N.Y. 1989) (finding that a defendant’s “false exculpatory statement” to an SEC investigator who interviewed him after the violative insider trade “evidences consciousness of guilt and has independent probative value of scienter”), *aff’d*, 898 F.2d 138 (2^d Cir. 1990); *SEC v. Lucent Techs., Inc.*, 363 F. Supp. 2d 708, 717 (D.N.J. 2005); *SEC v. Gold*, No. 05-CV-4713 JSMLO, 2006 WL 3462103 at *5 (E.D.N.Y. Aug. 18, 2006) (averral that auditors “attempted to conceal the deficiencies of their work” after the conclusion of the audit at issue by inserting false documents into audit work papers provided relevant factual basis for claim against them).

^{22/} See, e.g., *Alfred Clay Ludlum, III*, SEC Rel. No. 3628, 2013 SEC LEXIS 2024 at *33-*34 (July 11, 2013) (basing sanction in part on evidence that respondent took steps to conceal fraud and made misrepresentations to investigators); *Gary N. Kornman*, SEC Rel. No. 34-59403, 2009 SEC LEXIS 367 at *27 (Feb. 13, 2009) (respondent’s “deliberate attempt to deceive Commission investigators” “indicates a lack of honesty and integrity” and supports sanction), *petition denied*, 592 F.3d 173 (D.C. Cir. 2010).

^{23/} See FINRA Sanction Guidelines at 6-7 (Principal Considerations 10 and 12); *John Edward Mullins*, SEC Rel. No. 34-66373, 2012 SEC LEXIS 464 at *76, n.85 (Feb. 10, 2012); *Gregory W. Gray, Jr.*, SEC Rel. No. 34-60361, 2009 SEC LEXIS 2554 at *36 (July 22, 2009) (affirming sanctions based in part on consideration as aggravating factor that Gray sought to conceal his misconduct from his firm).

sanctions that, in his (and, he claims, the hearing officer's) view, he "cooperated in the Division's investigation." R.D. 210 at 3 (basing claim on statement by the hearing officer (I.D. 9) simply that the Division's efforts to "impeach Laccetti's testimony in various respects" by showing that he made prior inconsistent statements during his investigative testimony "failed to undermine the overall credibility" of his hearing testimony),

A view that would reject the basic concepts we have been discussing, or that would fail to recognize that subsequent conduct need not be charged as a violation to be considered as evidence of a violation that is charged, would be a poor foundation for concluding that proffered evidence "would be entitled to no significant weight in any event." To be sure, "the Division's characterizations of the statements in the various outline drafts are unquestionably subject to dispute," and those characterizations might have proven to be entirely mistaken. But generic, conclusory statements about a need to "embark on a possibly extensive inquiry into completely collateral events" if proffered evidence were admitted would not be an adequate basis for excluding it.

Erroneous exclusion of post-audit evidence, including restatement evidence,^{24/} could deprive the Board of information that it needs to properly analyze and evaluate, under the applicable auditing standards, the audit work at issue in a disciplinary proceeding. What the Board's rules require is fact-specific, case-by-case analysis of the admissibility of particular items of evidence in light of the specific details of that evidence, the particular circumstances of the case, and the particular foundation, reasoning, and authority offered for and against receiving the items into evidence. Rule

^{24/} The Division's petition for review had taken issue with the hearing officer's exclusion of more than the 11 exhibits that the Division went on to brief on appeal, including the exclusion of one of the documents relating to the restatement (proposed Ex. D-210). We consider the Division to have abandoned that broader challenge, but note that a restatement corrects an error in previously issued financial statements that is due to facts that existed at the time the financial statements were prepared, in contrast to a change in accounting estimate, which results from new information. See Accounting Principles Board Opinion No. 20 ¶ 13, *Accounting Changes*; Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, ¶¶ 2.h & j, 3.d. A restatement thus reflects and addresses facts that existed at the time of the original financial statements. The mere fact that financial statements are restated does not prove a violation of PCAOB auditing standards, see AU § 230.10, but this would not be a basis for the blanket exclusion of restatement evidence, without regard to any factual particulars. Indeed, AU § 230.13 states that the subsequent discovery of a material misstatement does not "in and of itself" evidence failure to obtain reasonable assurance; inadequate planning, performance, or judgment; the absence of due professional care; or a failure to comply with PCAOB standards, on the part of the auditor. This indicates that, depending on the circumstances, the subsequent discovery of a material misstatement may be used as evidence of those matters.

5441 does not warrant exclusion of post-audit evidence on the automatic or routine assumption that its probative value is substantially outweighed by, for example, a danger of unfair prejudice, confusion, undue delay, waste of time, or needlessly presenting cumulative evidence. Whether or not the third category of exhibits should have been admitted, the reasons given by the hearing officer for excluding them appear to have been incorrect or inadequate.

We have decided, however, not to reopen at this stage the ultimate matter of the admissibility of these or any other of the 11 exhibits whose exclusion the Division challenges in its appeal briefing. Given the ample evidence in the record, we need not and do not consider any of this additional material in deciding this case.

B. Laccetti's Challenge to the Hearing Officer's Admission of the Division's Expert Witness's Report and Testimony

Laccetti argues that the initial decision should be reversed due to the denial of his motion to exclude the Division's expert witness' report and testimony or to conduct a separate "evidentiary hearing to explore [the expert's] unreliable testimony and bias," which ruling below violated Laccetti's "right to due process and a fair hearing." R.D. 204 at 12-17, 19. ~~Even if the hearing officer had erred, the error is harmless because we do not rely on the expert. See generally *PDK Labs., Inc. v. DEA*, 362 F.3d 786, 799 (D.C. Cir. 2004) ("If the agency's mistake did not affect the outcome, if it did not prejudice the petitioner, it would be senseless to vacate and remand for reconsideration.").~~ We want to make clear, however, that the evidence was properly before us and we could have considered it, as Laccetti's claim of error is baseless.

Before the hearing, Laccetti moved to exclude the testimony and report of the Division's expert witness, on the grounds that the expert's report "contain[ed] inaccurate and misleading information" and was so "inherently biased" that it, and any related testimony given by the expert, could not be fairly relied upon. R.D. 72 at 1. Laccetti's claim was premised on the fact that the expert served as a consultant to the Division in this proceeding for several months before he was engaged to serve as an expert witness, but did not disclose this in his expert report. Laccetti asserted that the expert "purposely concealed his consulting role so that his inherent bias as a de facto member of the Division's investigative team was not disclosed." *Id.* at 2, 6. The hearing officer denied Laccetti's motion, noting, "Issues regarding an expert's bias, or inaccurate or misleading aspects of the expert's report, may be pursued through cross-examination at the hearing." R.D. 92 at 2. Laccetti now argues that this ruling was error "that infected the overall fairness of the hearing," and complains that, even though the hearing officer stated in the initial decision that he "gave only limited weight to the opinions offered by the expert witnesses," the decision nonetheless "agreed with numerous opinions offered by" the expert. R.D. at 18-19. Laccetti claims that "reversal" of the initial decision is the necessary cure for the hearing officer's "egregious error." *Id.* at 19.

The Board's review in this case is the cure of the error that Laccetti claims the hearing officer made. See, e.g., *Dearlove*, 2008 SEC LEXIS 223 at *34-35 & n.42 (*de novo* review of administrative law judge's initial decision), *aff'd*, 573 F.3d 801 (D.C. Cir. 2009). Specifically, we have conducted a *de novo* review of the record and base our findings and conclusions on the evidence in the record, without need for or use of the report or testimony of the Division's expert. There is an otherwise ample record in this case, and the Board, like the Commission, is fully capable of applying its own expertise to auditing matters and determining whether the evidence establishes conduct that failed to comply with PCAOB standards. See, e.g., *Dearlove v. SEC*, 573 F.3d 801, 805-806 (D.C. Cir. 2009). To the extent Laccetti argues that we can properly disregard the expert's testimony only by drawing no conclusions that are consistent with the expert's, we reject this logical fallacy. It is well within the Board's authority to make findings and draw conclusions based on the record evidence, regardless of whether such findings and conclusions agree with, or even flatly contradict, expert testimony.^{25/}

Even more fundamentally, Laccetti's claim of error itself is unfounded. Service as both consultant and expert is far from exceptional or problematic; to the contrary, as the Division has pointed out, the practice of engaging a single person to serve first as litigation consultant and then as expert witness is unremarkable and commonplace.^{26/} It is so common, in fact, that Laccetti's own expert and a co-respondent's expert each served as both consultant and witness.^{27/} Courts do not, as a general rule, exclude expert testimony on the grounds that serving as a consultant *per se* renders the

^{25/} See, e.g., *Wendy McNeeley, CPA*, SEC Rel. No. 34-68431, 2012 SEC LEXIS 3880 at *59-60 & n.54 (Dec. 13, 2012) (Commission "has its own expertise and is not bound by expert testimony regarding auditing standards") (citing *Haskins & Sells*, SEC Rel. No. 73, 1952 SEC LEXIS 1062 at *28 (Oct. 30, 1952)); *Dearlove*, 2008 SEC LEXIS 223 at *71 (expert testimony may be considered but is not binding); *Kirlin Securities, Inc.*, SEC Rel. No. 34-61135, 2009 SEC LEXIS 4168 at *56 n.74 (Dec. 10, 2009) ("neither we nor NASD is hindered by the lack of, or is bound by, expert testimony").

^{26/} See, e.g., *Bro-Tech Corp. v. Thermax, Inc.*, No. 05-CV-2330, 2008 U.S. Dist. LEXIS 21233 at *10-11 (E.D. Pa. Mar. 17, 2008); *Schwab v. Philip Morris USA, Inc.*, No. 04-CV-1945, 2006 U.S. Dist. LEXIS 11047 at *10 (E.D.N.Y. Mar. 20, 2006).

^{27/} See R.D. 88 (attaching (1) a Feb. 26, 2010 engagement letter stating that Laccetti's expert would be retained "as a consultant in connection with this representation," and that "[i]t is understood that at a later time it may be decided that you will prepare a report and/or testify in this matter as an expert witness"; and (2) a May 15, 2009 engagement letter explaining that the other respondent's expert's firm was being retained to "provide independent professional services" in the areas of "analysis of accounting and auditing issues" but that counsel had "not yet determined whether [it] will call any member of our firm as an expert witness in this matter").

testimony biased and unreliable. See, e.g., *MCC Mgmt. of Naples, Inc. v. Int'l Bancshares Corp.*, No. CIV-06-1345-M, 2010 U.S. Dist. LEXIS 10834 at *11-*12 (W.D. Okla. Feb. 8, 2010). It is well settled that bias is, instead, a question properly explored on cross-examination. See, e.g., *DiCarlo v. Keller Ladders, Inc.*, 211 F.3d 465, 468 (8th Cir. 2000) (rejecting argument that expert testimony should have been excluded on grounds of bias) (citing 4 WEINSTEIN'S FEDERAL EVIDENCE § 702.06[8] at 702-59 ("An expert witness's bias goes to the weight, not the admissibility of the testimony, and should be brought out on cross-examination.")). When courts do become concerned with differentiating the two roles, as illustrated by the cases Laccetti cites, it is often in the context of determining the extent to which the party offering the expert should be compelled to produce documents that were considered by the consultant/expert.^{28/}

Here, the document on which Laccetti has focused is a draft copy of the OIP that was provided to the Division's expert's firm a month before this proceeding was instituted. The Division gave the document to Laccetti before the hearing. It was nearly identical to the final OIP, and was properly omitted from an expert report whose only relevance is to the question of whether the charges in the final OIP—the operative charging document—were substantiated. Exclusion of an expert's report or testimony is an extreme remedy.^{29/} We can see no error in the hearing officer's decision to admit the expert's testimony and permit Laccetti to elicit evidence of bias on cross-examination.

Finally, the hearing officer did not err in declining to grant a pretrial evidentiary hearing in lieu of granting Laccetti's motion to exclude the expert's testimony. The threshold evidentiary hearing Laccetti requested (commonly called a *Daubert* hearing, after *Daubert v. Merrell Dow Pharms.*, 509 U.S. 579 (1993), and related cases) helps a federal court assess the validity of the methodology used in expert scientific or technical testimony based on several non-exclusive factors: (1) whether the theory or technique

^{28/} See, e.g., *Colindres v. Quietflex Mfg.*, 228 F.R.D. 567, 572 (S.D. Tex. 2005); *United States Fid. & Guar. Co. v. Braspetro Oil Servs. Co.*, No. 97 Civ. 6124, 2002 U.S. Dist. LEXIS 111 at *28-29 (S.D.N.Y. Jan. 7, 2002) (ordering production where claim of privilege failed because defending party could not "clearly establish" documents were made available to persons only while they were acting as consultants).

^{29/} See, e.g., *Derrickson v. Circuit City Stores, Inc.*, No. DKC 95-3296, 1999 U.S. Dist. LEXIS 21100 at *20 (D. Md. Mar. 19, 1999) ("Exclusion is a harsh sanction."); *Sullivan v. Glock, Inc.*, 175 F.R.D. 497, 504 (D. Md. 1995) (stating that exclusion of expert testimony in federal court "has traditionally been considered a severe sanction, appropriate only for willful and substantial abuse of the discovery process") (citing *McNemey v. Archer Daniels Midland Co.*, 164 F.R.D. 584, 586 (W.D.N.Y. 1995) ("[P]recluding testimony from an expert under [the Federal Rules of Evidence] is a drastic remedy and should only be applied in cases where the party's conduct represents flagrant bad faith and callous disregard of the federal rules.")).

in question can be and has been tested; (2) whether it has been subjected to peer review and publication; (3) its known or potential error rate; (4) the existence and maintenance of standards controlling its operation; and (5) whether it has attracted widespread acceptance within a relevant community. To the extent *Daubert* applies to administrative proceedings,^{30/} a *Daubert* inquiry is not styled to address personal bias, and a *Daubert*-style hearing is not an appropriate vehicle for doing so.^{31/} Laccetti, as well as his co-respondent, were properly given—and used—the opportunity to explore the expert's alleged biases through cross-examination during the hearing. For example, during that examination, Laccetti's counsel asked about, among other things, the extent of the work the expert performed for the Division in his role as consultant (answer: 7.75 hours over a six-month period), whether he had formed an opinion on the merits of the case before he agreed to serve as expert witness (answer: he had not), and whether all documents and information the expert reviewed in writing his report had already been made available to respondents (answer: they had). Laccetti has not articulated, and it is not apparent to us, how Laccetti's cross-examination of the Division's expert unfairly limited his ability to explore the expert's biases, or how a mini-proceeding dedicated to the subject of such bias would have, or could have, proven more useful or fair.

VII.

We reject the several affirmative defenses Laccetti presses on appeal.

^{30/} See, e.g., *Bayliss v. Barnhart*, 427 F.3d 1211, 1218 n.4 (9th Cir. 2005) (explaining that neither *Daubert* nor the Federal Rules of Evidence govern the admissibility of evidence in administrative proceedings) (citing *Richardson v. Perales*, 402 U.S. 389, 400 (1971)); *Nat'l Taxpayers Union v. United States Soc. Sec. Admin.*, 302 Fed. Appx. 115, 121-22 (3^d Cir. 2008) (unpublished) (declining "to endorse the application of *Daubert* to administrative proceedings" and to strike expert testimony); *but see Niam v. Ashcroft*, 354 F.3d 652, 660 (7th Cir. 2004) ("strictly speaking" neither Federal Rule of Evidence 702, nor *Daubert*, applies to administrative agencies but "the spirit of *Daubert*...does apply to administrative proceedings") (internal citations omitted).

^{31/} See, e.g., *Daubert*, 509 U.S. at 595 ("Vigorous cross-examination, presentation of contrary evidence, and careful instruction on the burden of proof are the traditional and appropriate means of attacking shaky but admissible evidence.") (citing *Rock v. Arkansas*, 483 U.S. 44, 61 (1987)). See also *United States v. 14.38 Acres of Land Situated in Leflore County, Mississippi*, 80 F. 3d. 1074, 1078 (5th Cir. 1996) ("[T]he trial court's role as gatekeeper is not intended to serve as a replacement for the adversary system."); *Cage v. City of Chicago*, 979 F. Supp. 2d 787, 827 (N.D. Ill. 2013) ("[I]t is well-established that an expert's bias is not a proper basis to bar testimony under *Daubert*."); *United States v. McCluskey*, 954 F.Supp.2d 1224, 1240 (D.N.M. 2013).

A. Right To Counsel

Laccetti argues that this proceeding should be dismissed because he was denied his “right to counsel during the investigative stage” when the Division did not allow a particular partner from Ernst & Young to attend Laccetti’s investigative testimony as an expert consultant. R.D. 204 at 12. This defense is moot because we need not and do not rely on his investigative testimony, but on other (and ample) record evidence. But, again, we want to make clear that use of the investigative testimony would in no way necessitate dismissal, because Laccetti has no sound basis for his claim of right.

Two months before Laccetti’s scheduled appearance to give testimony in the investigation of the Taro USA audit, Ernst & Young’s counsel asked that “when witnesses appear for testimony in this matter,” Board staff “permit the witness to be accompanied by a technical expert consultant.” R.D. 182 at 97; see R.D. 139a at 939-40 Counsel identified the consultant as a partner in Ernst & Young’s general counsel’s office, who could provide accounting and auditing expertise to counsel “at substantially less cost” than an outside technical consultant. R.D. 182 at 98. In denying that request by September 26, 2007 letter, the Division cited Board Rule 5102(c)(3)(iv). That rule limits those permitted to be present during investigative testimony to “the person being examined and his or her counsel, subject to Rule 5109(b); “any Board member or member of the staff of the Board”; “the reporter”; and “such other persons as the Board, or the staff of the Board designated in the order of formal investigation, determine are appropriate to permit to be present, provided, however, that in no event shall a person,” other than the witness, “who has been or is reasonably likely to be examined in the investigation be present.” The letter explained that excluding the expert was consistent with the release accompanying Board adoption of the rule. R.D. 180b at 2. In pertinent part, that release states that the Board “expect[s] the staff to be accommodating, but...also expect[s] the staff to be vigilant about not permitting a firm’s internal personnel effectively to monitor an investigation by sitting in on testimony of all firm personnel.” *Rules on Investigations and Adjudications*, PCAOB Rel. No. 2003-015 at A2-18-19. The concern is also reflected in Rule 5109(b)’s “provided, however” clause.

Laccetti gave his investigative testimony without an expert present. He now argues that the Division’s denial of the request to permit his chosen expert to attend “violated his right to counsel in at least three ways.” Even aside from the fact that we do not rely on his investigative testimony in deciding this case, which is the only prejudice Laccetti claims he would suffer, his arguments falter on his inability to establish the right he claims exists to attendance of a particular expert at his investigatory examination.

First, Laccetti notes that Rule 5109(b) confers a “Right to Counsel” during testimony before the Board, and argues that such right would be “meaningless if the examinee’s counsel could not provide effective assistance to his client.” In support of this argument, Laccetti cites *SEC v. Whitman*, 613 F. Supp. 48 (D.D.C. 1985). In *Whitman*, the court explained that “Congress expressly recognized that a witness

subpoenaed to testify before an agency has a right to representation under the Administrative Procedure Act (APA).” *Id.* at 49. The court then concluded that the SEC’s rules of practice, which excluded non-lawyers from attending its investigative proceedings and therefore worked to prevent counsel from being assisted by technical experts, improperly “impinge[d] upon counsel’s ability to adequately represent his client who has been called upon to testify,” running afoul of the APA’s grant of his client’s “absolute right to counsel during the proceedings.” *Id.*

As the Board stated in the release accompanying its adoption of Rule 5109 and other rules, and as Laccetti acknowledges in his brief (R.D. 204 at 14 n.18), the APA does not apply to Board proceedings.^{32/} But Laccetti urges us to look beyond the facial inapplicability of *Whitman* to take from it the premise that, where some “rule-based right” to counsel exists—here by virtue of Board Rule 5109(b)—then counsel must “have access to technical expertise” so as not to render that right “meaningless.”

We first note that it has long been recognized that, in administrative contexts, the right to counsel exists only where the Constitution or some statute, rule, or regulation creates it. *E.g., Seuss v. Pugh*, 245 F. Supp. 661, 665 (D. W. Va. 1965). In *Whitman*, the court found the source of a right to counsel in the APA, which the court characterized as providing an “absolute right to counsel.” 613 F. Supp. at 49. Here, Rule 5109(b) grants no such right; it allows circumscribed participation of a witness’s counsel in an investigative examination:

Any person compelled to testify pursuant to a subpoena issued pursuant to Rule 5111, or who appears pursuant to an accounting board demand or request, may be accompanied, represented and advised by counsel, subject to Rule 5102(c)(3), provided, however, that the counsel provide the Board’s staff with a notice of appearance that states, or state on the record at the commencement of testimony, that the counsel represents the witness. [Emphasis added.]

^{32/} See *Rules on Investigations and Adjudications*, PCAOB Rel. No. 2003-015 at A2-19 n.1 (“Whatever binding precedential value *Whitman* may have in the context of a Commission investigation, it has none in the context of a Board investigation. The *Whitman* decision rests on the requirements of the Administrative Procedure Act, which is not applicable to Board proceedings.”); see also 5 U.S.C. § 551(1) (defining “agency” for purposes of the APA as “each authority of the Government of the United States, whether or not it is within or subject to review by another agency,” with enumerated exceptions); 15 U.S.C. § 7211(b) (“The Board shall not be an agency or establishment of the United States Government....”); *Free Enterprise Fund v. PCAOB*, 561 U.S. 477, 485-86 (2010) (referring to “the [Sarbanes-Oxley Act] provisions specifying that Board members are not Government officials for statutory purposes”).

The participation allowed by Rule 5109(b) is thus expressly made subject to Rule 5102(c)(3), which, as noted, limits attendees to the examinee, his or her counsel, Board members and staff, and such other persons as the Board, or Board staff designated in the order of formal investigation determine are appropriate to permit to be present.

Laccetti suggests that the Board cannot limit the attendance of experts at investigative examinations by contending that any right to counsel, once granted by statute or rule, "necessarily carries with it the right to have counsel assisted by retained experts." R.D. 204 at 14 n.18. But all the cases he cites for this proposition turn on the Sixth Amendment right to assistance of counsel "in all criminal prosecutions." These cases are therefore inapposite; it is well settled that there is no general constitutional or statutory right to effective assistance of counsel outside of the criminal setting.^{33/}

Moreover, even if these cases applied to PCAOB proceedings, Laccetti could prevail on an ineffective assistance of counsel claim only if he could show that his defense was harmed for that reason, *i.e.*, that there is "a reasonable probability" that "the result of the proceeding would have been different." *Strickland v. Washington*, 466 U.S. 668, 694 (1984). Yet the Division did not exclude all experts, but only one, whose attendance the staff identified as inappropriate based on his employment by Ernst & Young. Any prejudice Laccetti claims to have suffered could fairly be attributed to his own decision not to seek out another expert in the two months before his scheduled examination. Nor does he claim to have been prevented from consulting with an expert in preparing for the examination, which lasted several days, or during breaks. And the only prejudice he claims is that "the Division's case rested in large measure on its use of Laccetti's investigative testimony." R.D. 210 at 23. Even if that assertion were true, it is irrelevant, because we have not relied on that testimony. Thus, even if Laccetti's flawed position were accepted, he has not shown that he would be entitled to any further relief than he is, in effect, receiving—"the typical remedy for a violation of the Sixth Amendment right to counsel," that "impermissibly obtained evidence is excluded."^{34/}

^{33/} *Hutcherson v. Smith*, 908 F.2d 243, 245 (7th Cir. 1990) ("It is a well-established principle of law that there is, in general, no constitutional or statutory right to effective assistance of counsel in civil cases."); *see also Hannah v. Larche*, 363 U.S. 420, 440 n.16 (1960) (Sixth Amendment "is specifically limited to 'criminal prosecutions'") (citing *United States v. Zucker*, 161 U.S. 475, 481 (1896)); *Williams v. Wynne*, 533 F.3d 360, 369 (5th Cir. 2008) ("the Sixth Amendment right to effective assistance of counsel is a criminal concept with no relevance to administrative or civil proceedings").

^{34/} *See Bradley v. Health Midwest, Inc.*, 203 F. Supp. 1254, 1259 (D. Kan. 2002) (citing *United States v. Thurmond*, 1998 U.S. App. LEXIS 7132 at *1 (10th Cir. Apr. 8, 1998) (unpublished)); *see also Massiah v. United States*, 377 U.S. 201, 207 (1964).

Second, Laccetti argues that because “the Board is ‘part of the Government’ for constitutional purposes,” citing *Free Enterprise Fund v. PCAOB*, 561 U.S. 477, 486 (2010), it must not infringe the Fifth Amendment right to due process, a “critical component” of which is the right to counsel. He cites nothing, however, to overcome well-established authority that, even when due process requires access to counsel, that right attaches only during an adjudicative proceeding—during which here he was assisted by counsel and an expert witness—not during an investigation. *Hannah v. Larche*, 363 U.S. 420, 440-43 (1960); *In re Groban*, 352 U.S. 330, 333 (1957).^{35/} His attempt to cast the same argument in terms of the requirement of Sarbanes-Oxley Act Section 105(a), 15 U.S.C. 7215(a), that the Board establish “fair procedures” for investigations fails for the same reasons that underlie those cases, Laccetti’s right to counsel was not infringed by exclusion of the particular expert from his examination.

Finally, Laccetti argues that even if *Whitman* and the Constitution are not a source of the right he claims to attendance of consultants during a Board investigatory examination, the SEC is compelled to recognize such a right in its own proceedings, with the result that the SEC would be unauthorized to approve sanctions imposed by the Board whenever a respondent’s expert consultant is excluded. The only support he cites for this argument is the statement in *Free Enterprise Fund*, 561 U.S. at 509, quoted without any context, that the SEC is “fully responsible for the Board’s actions.”

We can find no support in the law for the theory that restrictions under which the SEC may operate must pass through to organizations it oversees. Such a theory ignores Congress’s instruction that the PCAOB be established not as a government agency like the SEC but as a nonprofit corporation.^{36/} The theory also ignores the existence of securities industry self-regulatory organizations (SROs). SROs are

^{35/} *Accord, e.g., SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735, 742 (1984) (finding no offense to due process because “an administrative investigation adjudicates no legal rights”) (citing *Hannah*); *Anonymous v. Baker*, 360 U.S. 287, 295-96 (1959) (applying *Groban* to grand-jury-like proceeding); *United States v. Steel*, 238 F. Supp. 575, 577 (S.D.N.Y. 1965) (“[W]hen a government agency is conducting an investigation, as here, in contrast to making an adjudication, ‘due process’ does not require granting to those being investigated ‘rights...normally associated only with adjudicatory proceedings.’”) (quoting *Hannah*, 363 U.S. at 442); *Kevin Hall, CPA*, SEC Rel. No. 34-61162, 2009 SEC LEXIS 4165 at *73 (Dec. 14, 2009) (distinguishing adjudicative from investigative processes in the application of due process principles) (quoting *Friedman v. Rogers*, 440 U.S. 1, 18 (1979) and citing *O'Brien* and *Hannah*).

^{36/} See Sarbanes-Oxley Act Section 101(a) & (b), 15 U.S.C. 7211(a) & (b), quoted in *Free Enterprise Fund*, 561 U.S. at 484 (“Congress created the Board as a private ‘nonprofit corporation,’ and Board members and employees are not considered Government ‘officer[s]’ or ‘employee[s]’ for statutory purposes.”).

overseen by the SEC but reflect a congressional "prefer[ence] [for] self-regulation by a private body over direct involvement of a government agency," *First Jersey Secs., Inc. v. Bergen*, 605 F.2d 690, 698 (3^d Cir. 1979), "as a means of providing an opportunity for participants in the securities market to review the conduct of their peers in an informal and flexible manner" and of "achieving expeditious and flexible enforcement of legal and ethical standards," *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363, 1370-71 (5th Cir. 1980). If Laccetti were correct, SROs would be required to adhere to all federal constitutional provisions simply due to SEC oversight, but that is not so. *E.g.*, *Desiderio v. NASD*, 191 F.3d 198, 206 (2^d Cir. 1999) (citing *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345, 350 (1974)).

Moreover, the Board and SROs develop rules to carry out their missions, and provisions governing Commission review of Board or SRO rules do not require that they be the same as SEC rules, but rather that they meet certain standards. See 15 U.S.C. 7217(b); 15 U.S.C. 78s(b). The Board and SROs bring disciplinary proceedings, and while, in reviewing them, the Commission may consider whether the organizations applied their rules in a manner "consistent with [relevant statutory] purposes," the inquiry is not whether the rules were applied in the identical manner in which the SEC applies its rules. See, *e.g.*, 15 U.S.C. 7217(c)(2); 15 U.S.C. 78s(e)(1). Statutes require "fair procedures" or "a fair process" for such proceedings, not procedures or process identical to the SEC's. 15 U.S.C. 7215; 15 U.S.C. 78o-3(b)(8). In short, the Commission reviews proceedings according to the standards that apply to them, not to other proceedings. Laccetti's right to counsel defense is not only moot; it is baseless.

B. Separation of Powers

Laccetti argues that the Board should dismiss the charges against him because the statute that created the PCAOB "violates the [Constitution's] separation of powers, both on its face and as applied to these disciplinary proceedings." R.D. 204 at 19. The starting point of Laccetti's arguments is that the "Board's structure during the initiation, investigation, and prosecution of this matter" unconstitutionally "limit[ed] the SEC's authority to remove" Board members until the Supreme Court struck down, on separation of powers grounds, restrictions on removal of Board members other than for good cause (Sarbanes-Oxley Act, 15 U.S.C. §§ 7211(e)(6) & 7217(d)(3)) in *Free Enterprise Fund v. PCAOB*, 561 U.S. 477 (2010). According to Laccetti, dismissal of this proceeding is "compel[led]" by that case, as it establishes that the PCAOB generally exercised "unfettered, unaccountable enforcement authority" during the period the removal restrictions were in place, or, alternatively, dismissal is required for lack of a showing that "the SEC has ever exercised its authority over the Board with respect to this matter." R.D. 204 at 20-21. Neither argument has merit.

Regarding Laccetti's first argument, the Supreme Court's decision does not hold or even hint that the unconstitutionality of the statutory restrictions on the Commission's power to remove Board members invalidated "enforcement authority" exercised by the

PCAOB while those provisions were in place. As part of the same decision, the Court held that “the Board members have been validly appointed by the full Commission.” 561 U.S. at 513. It also made clear that “restricting certain officers to a single level of insulation from the President affects the conditions under which those officers might someday be removed, and would have no effect, absent a congressional determination to the contrary, on the validity of any officer’s continuance in office,” dismissing as without “any substance” a claim by the dissent that the work of various officials likened to Board members “will ‘be put on hold’” by the Court’s decision. *Id.* at 508. Although the petitioners in that case “argued that the Board’s ‘freedom from Presidential oversight and control’ rendered it ‘and all power and authority exercised by it’ in violation of the Constitution,” the Court “reject[ed] such a broad holding.” *Id.* Instead, the Court held that “the unconstitutional tenure provisions are severable from the remainder of the statute,” that the statute “remains ‘fully operative as a law’ with these tenure provisions excised,” and that petitioners were “not entitled to broad injunctive relief against the Board’s continued operations” but rather “declaratory relief” of excision of the unconstitutional provisions. *Id.* at 508, 513. Laccetti himself acknowledges that “the decision’s cure was prospective only.” R.D. 210 at 25. Nothing in the Court’s decision shows that vindication of the separation of powers requires invalidation of prior PCAOB actions in connection with a disciplinary proceeding.

Laccetti cites no authority in support of his position that we should interpret *Free Enterprise Fund* as invalidating any prior action taken by the PCAOB to investigate the basis for, institute, or prosecute a disciplinary proceeding. It is useful to note, however, that those few cases that were cited to the hearing officer when making similar (and unavailing) arguments below do not support Laccetti’s position. All of those cases involved persons who were fundamentally ineligible to act, such as where statutes authorized persons controlled by Congress to perform executive branch functions.^{37/} Laccetti has established no such fundamental ineligibility on the part of Board members.

^{37/} In *Bowsher v. Synar*, 478 U.S. 714 (1986), the Court held that a 1985 statute giving the Comptroller General certain new duties related to deficit reduction measures violated separation of powers principles because Congress had the authority to remove the Comptroller General. The Court explained that “[t]he structure of the Constitution does not permit Congress to execute the laws; it follows that Congress cannot grant to an officer under its control what it does not possess” and concluded that “the Comptroller General, as an officer removable by Congress, may not exercise the powers conferred upon him” by the statute. *Id.* at 726, 736 n.10. In *Metropolitan Washington Airports Authority v. Citizens for Abatement of Aircraft Noise*, 501 U.S. 252 (1991), the Supreme Court held unconstitutional a board of review composed of members of Congress that had veto power over the decisions of regional airport authorities. The statute creating this review body, the court held, “provides a blueprint for extensive expansion of the legislative power beyond its constitutionally confined role,” and was therefore impermissible. *Id.* at 276. In *FEC v. NRA Political Victory*

That is particularly significant to a separation of powers challenge, because, according to *Free Enterprise Fund*, what the separation of powers requires is that the President not be “impaired,” “subvert[ed],” or “limit[ed]” by law in his “ability,” “authority,” or “power” to execute the laws and thus that the Commission have “authority over,” and “wield a free hand to supervise,” Board members. 561 U.S. at 496, 498, 504, 513-14. The Court stressed that the “only issue in this case is whether Congress may deprive the President of adequate control over the Board.” *Id.* at 508. Eliminating an obstacle to the power to remove Board members does not require that the power actually have been exercised, or necessarily imply anything about the actions over which it might have been exercised, by a Board validly appointed, with authority severable from the removal provisions, and capable of continuing uninterrupted in office. This is clear from the Court’s statement that, in practice, the President “can always choose to restrain himself in his dealings with subordinates,” *id.* at 497, as can the Commission. And this is certainly true in the PCAOB context, where those choices would be made with the knowledge that “significant enforcement actions” by the Board “are, of course, subject to some latent Commission control,” including authority to review Board decisions like this one. *Id.* at 486, 504. The two successive administrations that defended the constitutionality of the statute were content with what the Court viewed as “[b]road, even if not ‘plenary,’ power over the Board—*id.* at 504.”

Furthermore, the “only oversight required” by *Free Enterprise Fund*—Commission authority to remove Board members at will—has existed all the way back to the start of the hearing in this case. Any claims by Laccetti that he was subjected to “unfounded accusations, prosecutorial misconduct, and due process violations” (R.D. 204 at 21 n.30) were, to the extent he properly raised them, presented for consideration and resolution by the hearing officer and now us, as what the Supreme Court called “a constitutional agency accountable to the Executive,” under a “fully operative” statute (561 U.S. at 508, 509, 513). We have given due consideration to the matters properly raised before us, and, for the reasons given, we have determined that specified charges against him were proven by a preponderance of the evidence and that this proceeding was conducted fairly and in accordance with applicable laws and rules. Although he notes that ultimate SEC review of a Board disciplinary sanction was held to be “insufficient to satisfy the separation of powers” (R.D. 204 at n.31)—as a substitute for striking down the removal restrictions—that does not mean that, in the wake of their

Fund, 6 F.3d 821 (D.C. Cir. 1993), the court found unconstitutional the composition of the Federal Election Commission, which had included agents of the legislative branch as *ex officio* members. It held that “the mere presence of agents of Congress on an entity with executive powers offends the Constitution.” *Id.* at 827.

excision, the further conduct of the proceeding by the hearing officer, *de novo* review by us, and the opportunity for further review by the Commission is an insufficient remedy.^{38/}

In, effect, Laccetti asks us to hold that the exclusive and essential remedy, if any PCAOB action were taken while the removal restrictions were in place to investigate the basis for, institute, or prosecute a pending disciplinary proceeding, is dismissal of the proceeding. This is so, in his view, regardless of whether any of those actions exceeded what the President or the Commission would have allowed, had they then possessed the power to remove Board members at will, and regardless of the Board members' eligibility to act, the nature of the separation of powers inquiry, the stance toward the PCAOB taken by successive Administrations, and the fact that the hearing and rest of the proceeding was conducted under the regime of *Free Enterprise Fund*, which had already ruled on the constitutionality of the statutory provisions. There is no warrant for Laccetti's position in anything cited to us or discovered in our research.

Laccetti's second argument would change the characterization of his constitutional challenge from "facial" to "as-applied" and reformulate the separation of powers inquiry as whether the Commission actually exercised or considered exercising "the executive power to start, stop, or alter" this "individual proceeding." R.D. 204 at 20-22 & nn.30, 31. Even if that were a proper standard for determining constitutionality, the Supreme Court has already declared the removal provisions unconstitutional. Laccetti's second argument offers nothing more than the first on the issue of remedy. Thus, it adds little, if anything, to the first argument, and fails largely for the same reasons.

As stated in a case Laccetti himself cites, he would bear the "burden to show" in an as-applied challenge "that the provisions of which [he] complains"—the removal restrictions—"are unduly severe," *i.e.*, "unduly constrain[] the President's ability to see that the laws are faithfully executed," in the "circumstances" here. See *Free Enterprise Fund v. PCAOB*, 537 F.3d 667, 670, 684 n.14 (D.C. Cir. 2008), *aff'd in part, rev'd in part, and remanded*, 561 U.S. 477 (2010). But the Supreme Court has already held that

^{38/} Contrary to Laccetti's contention that dismissal of an enforcement proceeding is required if there is a separation of powers problem, courts have recognized there can be "alternative way[s] of curing [a] constitutional violation." *FEC v. Legi-Tech*, 75 F.3d 704, 707-09 (D.C. Cir. 1996). Moreover, in *Doolin Securities Savings Bank, F.S.B. v. OTS*, the court indicated that, under commonly applied "harmless error" analysis, even if the charging document in an administrative proceeding were signed by an unauthorized official, this invalidity would not "cause the final order," which showed "detached and considered judgment in deciding the merits" by an authorized official, to be invalid. 139 F.3d 203, 212-213 (D.C. Cir. 1998). Compare *Landry v. FDIC*, 204 F.3d 1125, 1128, 1130-32 (D.C. Cir. 2000) (entertaining first-time claim that administrative law judge with purely recommendatory powers, to whom a statute required a matter be assigned, was invalidly appointed, despite agency's own determination of matter after *de novo* review).

the restrictions "contravene" and "violate the separation of powers" and thus are unconstitutional in all applications. 561 U.S. at 492, 508-10, 513-14. So for Laccetti to show that the Commission did not start, stop, or alter the present proceeding, or consider doing so, would be superfluous to establishing the unconstitutionality of the removal restrictions as applied to this case.

Further, Laccetti fails to provide any authority or analysis for why such a showing would require dismissal of this proceeding. Again, the Court held that once the restrictions were excised, the statute was "fully operative as a law" and the SEC was "fully responsible for the Board's actions, which are no less subject than the Commission's own functions to Presidential oversight," satisfying the separation of powers. *Id.* at 509. The four Board members participating in the review of this case are all eligible by law to act in that role, and three of those members did not sit on the Board when the proceeding was instituted. Thus, Laccetti's suggestion that this case could not continue after the Court's decision unless the President or the Commission then exercised, or considered exercising, the authority to "start, stop, or alter" the proceeding (R.D. 204 at 21-22 & nn.30, 31) would require dismissal simply because Laccetti disagrees with how the President or the SEC did or did not actually exercise their oversight authority over the Board. That is not for Laccetti to decide.

Moreover, Laccetti has not established that any failure by the Commission to act in the way in which he would have preferred was because the Commission was "prevented" from "exercising its authority over the PCAOB with respect to this matter" or that, as a result, he was subjected to a proceeding "fraught" with "unfounded accusations, prosecutorial misconduct, and due process violations" that otherwise "would not have occurred" or "would have been appropriately corrected," as he contends in his second argument (R.D. 204 at 20, 21 n.30). In defending the removal restrictions, the government expressed its view that the Sarbanes-Oxley Act did, in fact, provide the Commission with the authority to start, stop, and alter an individual PCAOB enforcement action. See, e.g., *Free Enterprise Fund*, 561 U.S. at 504-05. And had this proceeding been rife with the gross abuses claimed by Laccetti, the Commission could also have taken steps to remove unresponsive Board members for "willful abuse of authority" (*id.* at 503). Yet, as the hearing officer noted, despite the fact that, during the stage of this proceeding that preceded the Supreme Court's decision, the Commission "could have appointed a new Board majority, including a Chairman, because the Board Chairman position [was] vacant and the terms of two other Board members [had] expired," the SEC instead "withheld making new appointments." R.D. 138 at 3.

We thus reject Laccetti's contention, whether termed a facial or an as-applied challenge, that this proceeding must be dismissed on separation of powers grounds.

C. Taxation Power

As pertinent here, Section 109(d) of the Sarbanes-Oxley Act, 15 U.S.C. 7219(d), empowers the Board to establish and charge issuers "a reasonable annual accounting support fee...as may be necessary or appropriate to establish and maintain the Board." Laccetti argues that the support fee is a tax and that Congress impermissibly delegated its authority to the Board to levy such tax. R.D. 204 at 22-26; R.D. 210 at 5. We agree with the Division and the initial decision (I.D. 90) that Laccetti waived this affirmative defense by not timely raising it and that, in any event, the defense has no merit.^{39/}

Board Rule 5421(c) requires a respondent to assert any "matter constituting an affirmative defense" in his or her answer, and it is undisputed that Laccetti's challenge to the fee provision is an affirmative defense. "It is a frequently stated proposition of virtually universal acceptance by the federal courts that a failure to plead an affirmative defense as required by Federal Rule [of Civil Procedure] 8(c) results in the waiver of that defense and its exclusion from the case." See 5 C. Wright & A. Miller, Fed. Prac. & Proc. § 1278 (3d ed.). That proposition applies even to defenses that might be characterized as purely legal in nature. See, e.g., *J & J Sports Prods. v. Delgado*, 2013 U.S. Dist. LEXIS 91447 at *13 (E.D. Cal. June 28, 2013) (defense "must be articulated to such a degree that the plaintiff is not subject to unfair surprise") (citing *Woodfield v. Bowman*, 193 F.3d 354, 362 (5th Cir. 1999)). Courts considering whether affirmative defenses have been waived are concerned not only about prejudice to the parties asserting the defenses but also about the resources of litigants and tribunals that might be wasted on lengthy proceedings unless parties are required to properly raise their defenses.^{40/} The SEC, while recognizing that Federal Rule of Civil Procedure 8(c) does

^{39/} We assume, for purposes of this opinion, that Laccetti has standing to make this challenge. As the Division points out, the initial decision held that Laccetti lacked standing because he was not an issuer, from whom the support fee is collected, but an associated person of a registered firm that audits issuers. I.D. 90. But neither the initial decision nor the Division has addressed Laccetti's theory that he has standing because if the fee provision is held unconstitutional, and is not severable from the rest of Title I of the Sarbanes-Oxley Act, see generally *Alaska Airlines, Inc. v. Brock*, 480 U.S. 678, 684 (1987), he would enjoy complete relief from this enforcement proceeding, see generally *Fed. Election Comm'n v. NRA Political Victory Fund*, 6 F.3d 821, 824 (D.C. Cir. 1993).

^{40/} See, e.g., *Robinson v. Johnson*, 313 F.3d 128, 137 (3^d Cir. 2002) ("Affirmative defenses must be raised as early as practicable, not only to avoid prejudice, but also to promote judicial economy. If a party has a successful affirmative defense, raising that defense as early as possible, and permitting a court to rule on it, may terminate the proceedings at that point without wasting precious legal and judicial resources."); *Bradford-White Corp. v. Ernst & Whinney*, 872 F.2d 1153, 1160-61 (3^d Cir. 1989) (where defendant "did not file a motion or present argument before the district court on

not apply to Commission proceedings, has nonetheless looked to it for guidance in holding that an affirmative defense is waived if not raised in a timely fashion. See *Russell Ponce*, SEC Rel. No. 34-43235, 2000 WL 1232986 at *11 & nn.53-54 (Aug. 31, 2000) (statute of limitations), *aff'd*, 345 F.3d 722 (9th Cir. 2003). In the interests of fairness and economy of the adjudication process—benefits that would accrue to all involved in Board proceedings—affirmative defenses should be timely raised.

Laccetti claims he raised the tax issue at the end of his answer to the OIP as his “Eighth Affirmative Defense.” That defense merely asserted, “The proceedings instituted against Mr. Laccetti are invalid because the establishment and structure of the PCAOB violates the U.S. Constitution.” R.D. 10 at 13 (omitting appended footnote: “Mr. Laccetti reserves the right to amend his Answer and interpose additional affirmative defenses as appropriate.”). In a March 4, 2010 pre-hearing conference, his counsel construed that defense as raising “the issues that are related to the case now pending before the Supreme Court [in *Free Enterprise Fund*],” namely, “these issues” “about the structure of the PCAOB and the power of the president to appoint and remove board members,” and construed it again, in moving on to discuss other affirmative defenses in the answer, by saying, “separate and apart from the issues before the Supreme Court, what we want to do is really raise issues related to the rights that we think should be afforded by the rules of the PCAOB to all respondents.” R.D. 29 at 11-13. No mention was made of the support fee provision. It was not before the Supreme Court; challenge was made there only to the provisions for appointment and for-cause removal of Board members by the Commission. 561 U.S. at 487-88.

Furthermore, on June 28, 2010, the first scheduled day of the hearing, Laccetti’s counsel successfully requested a one-day postponement because the Supreme Court had decided *Free Enterprise Fund* that morning. The next day, counsel made an oral application to the hearing officer to dismiss the case on the basis of the Court’s decision and, failing that, for “expedited interlocutory appeal under PCAOB [Rule] 5461,” asserting that Laccetti was “going to suffer irreparable harm by having to go through this proceeding when the whole proceeding in itself was the by-product of unconstitutional decisionmaking”; contending that “this issue certainly involves a controlling question of law”; and recognizing that “it was very important to make this application as soon as possible.” R.D. 134 at 8-9; R.D. 135 at 29, 35-37. Laccetti now characterizes the support fee provision as an even more fundamental defect in the statute: “Unlike the [removal] provision at issue in *FEF*, Sarbanes-Oxley is not ‘fully operative as a law’ with the funding provisions excised.” R.D. 204 at 26 n.35. Yet he failed to articulate a constitutional challenge in terms of the fee provision or Congress’s taxation authority until his October 29, 2010 post-hearing submission. See R.D. 180 at 115-18. Under the circumstances of this case, Laccetti waived that defense by failing timely to raise it.

the statute of limitations issue [raised in its answer] at any time before or at the trial,” but tried to argue issue in post-trial brief, finding “it would be grossly unfair to allow a plaintiff to go to the expense of trying a case only to be met by a new defense after trial”).

Even if Laccetti had properly raised the defense, however, it fails on the merits. The Board's congressional authorization to collect a support fee is not unconstitutional because, quite simply, the fee is not a tax within the meaning of the Constitution. Article I, Section 8 of the Constitution grants exclusively to Congress the "power to lay and collect taxes," which may not be delegated without meeting certain minimum constitutional requirements. *Skinner v. Mid-Am. Pipeline Co.*, 490 U.S. 212, 223 (1989). Not all levies authorized by Congress, however, are taxes. In 1884, the Supreme Court held that a fee collected from all ship owners for each non-citizen passenger entering the United States was not a tax under Article I, Section 8. *Head Money Cases (Edey v. Robertson)*, 112 U.S. 580 (1884). The Court explained that the statute authorizing the fee designated the money to "defray the expense of regulating immigration," not for "the general support of the government," and was not an exercise of Congress's taxing power; instead, the fee was "the mere incident of the regulation of commerce" and well within the authority of Congress to impose. *Id.* at 590, 595-96.

Courts have continued to recognize this distinction between taxes and fees in analyzing constitutionality under Article I, stressing the fundamental difference between monies raised for general government use and those for regulation. For example, the Ninth Circuit held that a state levy imposed on railroads doing business in the state was not an unconstitutional tax. *Union Pac. R.R. Co. v. Public Util. Comm'n*, 899 F.2d 854, 859 (9th Cir. 1990) (citing *Head Money Cases*). In so holding, the court explained that "the concerns underlying the constitutional limitations imposed on the taxing power by article I, section 8 are relevant to measures having the primary objective of raising revenues for the general support of government, but not to measures having the primary objective of regulating commerce." When a statute serves the limited fiscal purpose of defraying costs related to a regulatory program rather than raising general revenues, a levy does not run afoul of Article I. *Id.*; *Chicago & N.W. Transp. Co. v. Webster Co. Bd. of Supervisors*, 880 F. Supp. 1290, 1306 (N.D. Iowa 1995) (a fee is not a tax unless it generates revenue "to offset unrelated costs or confer unrelated benefits" (emphasis in original) (citing *Digninet, Inc. v. Western Union ATS, Inc.*, 958 F.2d 1388, 1392-93 (7th Cir. 1992)). A number of other courts have reached the same conclusion. See *South Carolina ex rel. Tindal v. Block*, 717 F.2d 874, 887 (4th Cir. 1983) ("If regulation is the primary purpose of a statute, revenue raised under the statute will be considered a fee rather than a tax."); *United States v. Stangland*, 242 F.2d 843, 848 (7th Cir. 1957) (quoting *Rodgers v. United States*, 138 F.2d 992, 994-95 (6th Cir. 1943) ("The imposition with which we are concerned has for its object the fostering, protecting and conserving of interstate commerce and the prevention of harm to the people from its flow. It is not a charge on property for the purpose of raising revenue.")).^{41/}

^{41/} See, e.g., *San Juan Cellular Tel. Co. v. Public Serv. Comm'n*, 967 F.2d 683, 685 (1st Cir. 1992) ("Courts have had to distinguish 'taxes' from regulatory 'fees' in a variety of statutory contexts. Yet, in doing so, they have analyzed the legal issues in similar

Laccetti addresses none of this authority. The only case he cites in support of his claim that the support fee is a tax is of no help to him. The case's discussion of taxes and fees was geared to the distinctive statute and type of fee at issue there, which are very different from those at issue here.^{42/} The Board's support fee, which, as pertinent here, is collected from public companies and which defrays the cost of overseeing the audits of those companies, is not a tax within the meaning of Article I.

Finally, even if the support fee were a tax, Laccetti acknowledges that there would be no constitutional problem unless Congress improperly delegated its taxing power to the PCAOB. R.D. 204 at 23. The Constitution only permits delegation where

ways. They have sketched a spectrum with a paradigmatic tax at one end and a paradigmatic fee at the other. The classic 'tax' is imposed by a legislature upon many, or all, citizens. It raises money, contributed to a general fund, and spent for the benefit of the entire community. The classic 'regulatory fee' is imposed by an agency upon those subject to its regulation. It may serve regulatory purposes directly by, for example, deliberately discouraging particular conduct by making it more expensive. Or, it may serve such purposes indirectly by, for example, raising money placed in a special fund to help defray the agency's regulation-related expenses.") (citations omitted).

^{42/} Specifically, the statute at issue in *National Cable Television Association, Inc. v. United States*, 415 U.S. 336, 340 (1974), authorized federal agencies to collect a "fee, charge, or price" for any "work, service,...benefit,...license,...or similar thing of value" that is "granted, prepared, or issued by" them "to or for any person," considering, among other things, "the value to the recipient" and "public policy or interest served, and other pertinent facts." The Court noted that: (1) the specific wording about "benefit" or "value" to the payer, as informed by legislative intent, was inconsistent with a tax; (2) a "public agency performing those services" relevant to the statute "normally may exact a fee for a grant, which, presumably, bestows a benefit on the applicant, not shared by other members of society"; and (3) "[t]he words 'public policy or interest served, and other pertinent facts,'" which, "if read literally," might, in its "ultimate reach," "bestow on a federal agency the taxing power," did "not seem to be relevant to the present case." Accordingly, the Court resolved the "contrast[]" in language and "read the Act narrowly" to permit agencies to collect only fees that represent the value of a service received by the fee payer. *Id.* at 341-44. As courts have recognized, the case "was not announcing universal definitions of 'tax' and 'fee'" but instead was addressing "a particular context," one quite different from that in which regulation is a statute's primary purpose. *Union Pacific*, 899 F.2d at 861; *accord, e.g., San Juan Cellular*, 967 F.2d at 686 (distinguishing *National Cable* as focused on a statute that required evaluating whether the fee at issue provided "value to the recipient" and holding that "money [that] is not used for a general purpose but rather to defray[] the expenses generated in specialized investigations and studies, for the hiring of professional and expert services and the acquisition of the equipment needed for the operations provided by law for the [agency]" is not a tax).

Congress “shall lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform.” *Hampton & Co. v. United States*, 276 U.S. 394, 409 (1928). Laccetti bears the burden of showing that this standard was not met. *Yakus v. United States*, 321 U.S. 414, 426 (1944). Contrary to Laccetti’s unsupported assertion (R.D. 204 at 24 n.33), the standards of a delegation of power must be examined not “in isolation,” but also by deriving “meaningful content from the purpose of the [statute], its factual background and the statutory context.” *Florida Power & Light Co. v. United States*, 846 F.2d 765, 776 n.9 (D.C. Cir. 1988) (quoting *American Power & Light Co. v. SEC*, 329 U.S. 90, 97 (1946)). And also contrary to his conjecture (R.D. 204 at 23), “the delegation of discretionary authority under Congress’ taxing power is subject to no constitutional scrutiny greater than that...applied to other nondelegation challenges.” *Rural Cellular Ass’n v. FCC*, 685 F.3d 1083, 1091 (D.C. Cir. 2012) (quoting *Skinner v. Mid-America Pipeline Co.*, 490 U.S. 212, 223 (1989) and citing *Whitman v. American Trucking Ass’ns*, 531 U.S. 457, 472 (2001)).

Sarbanes-Oxley Act Section 109(d)(1) provides that the support fee is to “establish and maintain the Board.” 15 U.S.C. 7219(d)(1). Section 101 provides that the PCAOB is established “to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.” 15 U.S.C. 7211(a). Sections 102 through 106 describe the Board’s ongoing responsibilities for registration, for auditing, quality control, and independence standards and rules, for inspections, for investigations and disciplinary proceedings, and with regard to foreign public accounting firms. 15 U.S.C. 7212-7216. Section 109(d)(2) calls for “the equitable allocation, assessment, and collection” of the support fee “among issuers, in accordance with subsection (g),” which provides that any amount due from issuers “shall be allocated among and payable by each issuer (or each issuer in a particular class, as applicable) in an amount equal to the total of such amount, multiplied by a fraction” based on “average monthly equity market capitalization” for a particular 12-month period of the issuer compared to all such issuers. 15 U.S.C. 7219(d)(2) & (g). Considered as standards for delegation, these are more than sufficiently precise to satisfy the Constitution. See, e.g., *Florida Power & Light*, 846 F.2d at 775-76 (cataloguing very general delegations upheld by the Supreme Court).

We therefore reject Laccetti’s constitutional challenge to Section 109(d).

VIII.

Sarbanes-Oxley Act Section 105(c)(4) authorizes the Board to impose “such disciplinary or remedial sanctions as it determines appropriate,” subject to certain limitations, on registered public accounting firms or associated persons of such firms if the Board “finds, based on all of the facts and circumstances,” that the firm or person has violated PCAOB rules and auditing standards. 15 U.S.C. 7215(c)(4). With respect to a proceeding against an associated person, such as here, Section 105(c)(5) specifies

that a suspension, bar, or limitation on the activities or functions of such person, as well as civil monetary penalties in excess of \$100,000, "shall only apply" to "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard" or to "repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." 15 U.S.C. 7215(c)(5). In this context, recklessness "represents an 'extreme departure from the standards of ordinary care,...which presents a danger' to investors or the markets 'that is either known to the (actor) or is so obvious that the actor must have been aware of it.'" *S.W. Hatfield, CPA*, SEC Rel. No. 34-69930, 2013 SEC LEXIS 1954 at *77 (July 3, 2013) (citation omitted). Applicable PCAOB auditing standards provide the standard of care for assessing the auditor's conduct. *Id.*

The Board's determination of appropriate sanctions is guided by the purpose for which it was established: "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." See Sarbanes-Oxley Act Section 101(a), 15 U.S.C. 7211(a); *see also* Section 101(c)(5), 15 U.S.C. 7211(c)(5) (in identifying duties of Board, referring to objective "to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof" or "otherwise to carry out this Act, in order to protect investors, or to further the public interest"). In making this determination, the Board also draws guidance from the grounds on which the Act authorizes the Commission to disturb Board sanctions: a finding, with "due regard for the public interest and the protection of investors," that the sanction "is not necessary or appropriate in furtherance of this Act or the securities laws" or "is excessive, oppressive, inadequate, or otherwise not appropriate to the finding or the basis on which the sanction was imposed." Section 107(c)(3), 15 U.S.C. 7217(c)(3).

Furthermore, this statutory sanctioning authority was fashioned specifically to apply in actions to enforce compliance with the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the related obligations and liabilities of accountants, by registered public accounting firms and their associated persons. We therefore exercise that authority not only with fidelity to the particular language of the statute that created it but also ever-mindful of the particular role of the auditor.

As the Supreme Court has explained, "[b]y certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility"—a "special" "'public watchdog' function" of "a disinterested analyst charged with public obligations." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (emphasis in original). Other court cases have recognized "the particularly important role" played by auditors in "certifying the accuracy of financial statements of public companies that are so heavily relied upon by the public in making investment decisions," pointing out that "the confidence of the investing public in the

integrity of the financial reporting process” and in the reliability of financial information, needed “[f]or the market to operate efficiently—indeed, for it to operate at all,” is “bolstered by the knowledge that public financial statements have been subjected to the rigors of independent and objective investigation and analysis.” *McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005); *Marrie v. SEC*, 374 F.3d 1196, 1200-01 (D.C. Cir. 2004). As another court observed, “[b]reaches of professional responsibility” by members of the accounting profession “jeopardize the achievement of the objectives of the securities laws” and “can inflict great damage on public investors.” *Touche Ross & Co. v. SEC*, 609 F.2d 570, 580-81 (2^d Cir. 1979). The Commission and investors “rely heavily on accountants to assure corporate compliance with federal securities law and disclosure of accurate and reliable financial information.” *Dearlove*, 2008 SEC LEXIS 223 at *108 (citation omitted). While an auditor is “not a guarantor of the accuracy of financial statements of public companies,” the “investing public rely heavily on auditors to perform their tasks in auditing public companies diligently and with a reasonable degree of competence.” *Wendy McNeeley, CPA*, SEC Rel. No. 34-68431, 2012 SEC LEXIS 3880 at *40 (Dec. 13, 2012) (internal quotation marks omitted); see AU § 230.10, .13 (the auditor “is not an insurer and his or her report does not constitute a guarantee,” but it “is based on the concept of obtaining reasonable assurance,” through the exercise of due professional care, that “the financial statements are free of material misstatement, whether caused by error or fraud”). Thus, an audit is an important line of defense against unreliable financial information that harms the markets and investors.

The seriousness with which Congress viewed the audit role is indicated by the sanctions it authorized the Board to impose in auditor disciplinary proceedings under the Sarbanes-Oxley Act. Under the statute, available sanctions for a violation found by the Board could include the permanent revocation of a registered public accounting firm’s registration, the permanent bar of a person’s association with such a firm, and, for the period at issue here, per-violation civil money penalties of up to \$750,000 for an individual and \$15 million for a firm. Section 105(c)(4) & (5), 15 U.S.C. 7215(c)(4) & (5).

Having found, after careful review of the record, that Laccetti violated PCAOB rules and auditing standards, as previously discussed, we proceed to determine what sanctions are authorized under Sarbanes-Oxley Act Section 105(c) and are otherwise appropriate for that conduct. We first address the main violations and, after that, the failure to perform the retrospective review, in violation of AU § 316.64.

A. Sanctions Determinations for the Main Violations

1. Recklessness

Laccetti’s conduct that resulted in his violations of AU §§ 150, 230, 326, 329, 333, and 342 was an extreme departure from the standard of care and presented a danger to investors and the markets that was either known to him or was so obvious he must have been aware of it. That pattern of conduct went far beyond merely making

mistakes or errors in judgment. The Commission has described recklessness as “an egregious refusal to see the obvious or investigate the doubtful,” exemplified by an auditor who “held his nose, closed his eyes, and signed off on the audit report, even though the circumstances” plainly required substantial additional audit work and evidence and may even have required a qualified opinion or a disclaimer of opinion. See *Barrie C. Scuttillo*, 56 SEC 714, 2003 WL 21738818 at *9 (July 9, 2003), quoted in *Hatfield*, 2013 SEC LEXIS 1954 at *80. We conclude that Laccetti’s conduct reached that level. And in acting in that way, Laccetti put investors at risk.

Laccetti was the auditor with final responsibility for the 2004 Taro USA audit. In both planning and conducting the audit, Laccetti recognized that there were serious questions about the adequacy of Taro USA’s year-end 2004 sales allowance reserves. The company’s use of sales allowances was integral to the type of company it was and to the accounting and auditing issues it generated. See, e.g., R.D. 137 at 749-52. As the principal auditor’s engagement partner pointed out, “[t]here is no manufacturing” at Taro USA, “90 percent of [the parent company’s] sales are there,” and “revenues and the AR allowances” is “a fundamental issue...in its operations.” R.D. 141 at 1458-59; see Ex. J-17 at 29, 47. As the partner further observed, whether the product price was fixed or determinable at the time of sale, given sales allowances, is the most significant issue for revenue recognition in the pharmaceutical industry. R.D. 142 at 1800-01.

The risk of material misstatement of Taro USA’s sales allowance reserves was not a latent issue. From the start of the 2004 audit, Laccetti’s attention was specifically directed to that risk. The unusual, dramatic drop in second-quarter sales and the discovery of the extensive chargebacks overpayments strained an estimation process the auditors already did not regard as strong. According to Laccetti, he was well aware of the risk of material misstatement and “created [the 2004] audit plan with the hope of gaining as much information from Taro US as possible” about those reserves. R.D. 135 at 273-74; R.D. 180a at 61. During the field work, he expressed concerns to Taro USA and the principal auditor about the reserves, initially determined that the support offered for them was inadequate, requested additional evidence, and for the rest of the audit continued to view the “AR” issue as “tough.” Unlike with the other individual reserves, management did not provide any calculations to support the part of the overall reserves represented by chargebacks or even a clear explanation of how it had been determined. Audit testing showed a striking and ill-explained drop in that part of the reserves, which had represented 45% of the total only the year before, and also showed a substantially worsening cash collection problem that could signal inadequate reserves.

Yet Laccetti did not employ sufficient professional care, including heightened professional skepticism. Instead, he acquiesced in management’s view that it was too difficult to match any chargebacks and sales and to provide a detailed calculation for that reserve, abandoned any plans to subject that part of the reserves to direct, detailed audit testing, such as he otherwise used in the high-risk area of sales allowance estimates, accepted an insupportable explanation for the steep drop in the chargebacks

reserve, selectively adjusted 2004 days sales in accounts receivables downward, and relied exclusively on that and other overly general, inapt, or flawed procedures, repeatedly involving untested management assertions, as the only testing for that part of the reserves. With evident hesitation, Laccetti then expressed an unqualified opinion to the principal auditor.

Laccetti could not have failed to appreciate that acceptance of Taro USA's total year-end 2004 accounts receivable reserves balance under these circumstances presented a danger to those relying on rigorous, objective audit inquiry and analysis. He knew that Taro USA's parent company was publicly traded on the NASDAQ National Market and reported its consolidated financial statements in SEC filings. He also knew that Taro USA made most of the parent company's sales. R.D. 135 at 197. Indeed, since at least 2002, more than 85% of the parent company's recorded consolidated net sales and more than 90% of its recorded consolidated year-end net accounts receivable and accounts receivable reserves came from Taro USA. And Laccetti knew that chargebacks was by far Taro USA's single largest sales adjustment at year end 2003 and 2004 and the largest component, again by far, of its year-end 2003 accounts receivable reserves, before the chargebacks reserve plummeted by year end 2004 for reasons he has never been able to explain or justify.

Laccetti's arguments that he did not act recklessly are based almost entirely on his view that he did not violate the pertinent PCAOB standards in the first place, a view we have rejected for reasons previously discussed. Nothing in the "context in which the 2004 Taro USA engagement took place"—"prior to the point when [the parent company] had to adopt the sweeping internal control reforms that were ushered in with the Sarbanes-Oxley Act of 2002" (R.D. 204 at 3, 26)—excused Laccetti's disregard of some of the most basic auditing principles. These were principles such as exercising due professional care, including maintaining an attitude of professional skepticism, obtaining sufficient competent evidential matter to afford a reasonable basis for an opinion, and performing audit procedures that are appropriate for the risks of material misstatement.

Laccetti also argues that he "did not act with a reckless state of mind when considering" the part of the accounts receivable reserves balance represented by chargebacks because he undertook "extensive testing" of the other "components of the accounts receivable reserve," which he assessed individually, "as well as other aspects of the Taro USA audit engagement," including "a short-dated inventory issue, a computer system issue, a complex licensing agreement, tax issues, and a barter transaction." R.D. 204 at 26-27. A general inference such as he asks us to draw from other audit work cannot overcome what the ample, detailed, and direct evidence about the audit work at issue shows, namely that the latter was seriously deficient and posed an obvious danger. Briefs merely multiplying citations to unrelated or insufficient audit work do not change the fact that Laccetti "look[ed] the other way despite suspicions" (*Marrie*, 374 F.3d at 1204) in the audit work we are discussing here. See *Dearlove*, 2008 SEC LEXIS 223 at *106 (evidence that an auditor "spent substantial time and

effort on some auditing areas does not insulate him from liability for his failure to spend enough time and effort" on another area "so material to" the financial data under audit).

We recognize that Laccetti's prior experience auditing pharmaceutical companies was limited to serving as senior manager on the 2003 Taro USA audit. And he asserts that his 2004 audit "strategy was similar to that of the prior year" in assessing the part of Taro USA's sales allowance reserves balance represented by chargebacks through procedures on the total reserves balance. R.D. 180 at 93 (quoting investigative testimony of senior manager); R.D. 180a at 175. Indeed, at times, Laccetti's hearing testimony reads as if he merely copied language from 2003 Taro USA audit documents for the 2004 audit (see, e.g., R.D. 135 at 281-82, 380-84), and reliance on the 2003 audit is a frequent refrain in the senior manager's investigative testimony (Exs. L-181 at 36-37, 48-52, D-303 at 20, 27, 42-51, 57-58, 81-82, 161, 165-66).

Laccetti was, however, an experienced auditor. After graduating from college in 1989, Laccetti worked for 11 years at Ernst & Young as a staff accountant, senior accountant, manager, and senior manager. After transferring for three years to the firm's business risk services group, he returned to the audit practice in December 2003, and was promoted to partner, effective July 1, 2004. R.D. 137 at 661-64, 667; I.D. 15. Whatever strategy he employed in the 2004 Taro USA audit, he needed to effectively respond to the combination of circumstances he faced. He accepted the role of auditor with final responsibility for that audit, and he claims to have exercised his professional judgment and appreciated and addressed the risks presented by Taro USA's accounts receivable reserves, auditing around the difficulties he faced. And we note that he does not claim, nor does the record show, that he sought any assistance in resolving what he acknowledges was the "tough" and "problematic" area of Taro USA's 2004 accounts receivable reserves from the long-serving engagement partner who preceded him in that role on the Taro USA audits, independent reviewer on the audit, or principal auditor, or more generally from his firm's professional practice group, consisting of "partners and senior managers throughout the firm who are available to assist and consult with" an audit team (R.D. 139a at 964-66). Interestingly, Laccetti points out to us in his brief that, in an unrelated area of the audit, he "required Taro USA to record a \$2 million adjustment" to its short-dated inventory reserve (R.D. 204 at 27 & n.36), yet he indicated in his testimony that this was an area in which he was in "consultations...with our professional practice group" about an "inventory analysis" (R.D. 139a at 950).

By contrast, Laccetti kept deliberations about the adequacy of Taro USA's 2004 accounts receivable reserves within the 2004 audit team. It was a team that had changed around Laccetti since the prior year. It had two other members. One was a senior manager who testified in the investigation that he joined Ernst & Young in October 2004, after some experience at two other audit firms, and "expressed reservations [to Laccetti] about working on a public client since I didn't have any experience" with audits of public companies or pharmaceutical companies. Ex. D-303 at 7-16. The senior manager had "very minimal work with respect to revenue

recognition," limited to "[r]ecruiting and personnel firms, mostly service related." *Id.* at 9-11; *see id.* at 96-97, 105-07, Ex. D-315 at 4 (further references by senior manager to his lack of experience). And the senior manager thought it was responsive to the Israeli engagement partner's question about whether Laccetti was completely satisfied with the existing level of Taro USA's reserves simply to refer to the Summary Review Memorandum and remark to Laccetti, "I think we are as comfortable as we can get." Ex. D-256 at 1; Ex. D-98. The last team member was a staff accountant who Laccetti testified had been with Ernst & Young for two years, had some prior experience, but "didn't have the same level of experience" as the senior auditor on the 2003 audit, and served as "acting senior" auditor. R.D. 137 at 707; R.D. 139a at 1009-11.

In spite of all of this, Laccetti reported ultimate satisfaction with the total sales allowance reserves balance. And he did so in summary memoranda that used language consistently suggesting that audit procedures were more substantial and extensive than they were. *See pp.* 19, 23, 49, 50, 60-61 above. Ultimately, faced with a deadline for completing the audit, Laccetti had to choose between signing off on the audit or continuing to press his questions and concerns about the sales allowance reserves. Investor interest required the latter, but Laccetti chose the former. In violating AU §§ 150, 230, 329, 326, 333, and 342, as we have found, Laccetti acted recklessly.

2. Sanctions

For violations such as those found here, the Sarbanes-Oxley Act calls on the Board to determine and impose appropriate sanctions, within specified parameters. In determining appropriate sanctions, we consider the nature, seriousness, and circumstances of the violations and any potentially aggravating or mitigating factors supported by the record, all through the lens of our statutory responsibility to protect investors' interests and further the public interest in the preparation of informative, accurate, and independent issuer audit reports.

Laccetti's reckless conduct ill-served the investor interests and public interest that an audit should serve, falling far short of the rigorous, objective inquiry and analysis required by PCAOB standards. Taro USA's year-end 2004 sales allowance estimates played a key role in the company's recognition of revenue and its valuation of approximately 40% of the current assets on its balance sheet. *See, e.g.,* Ex. D-125 at 15. Laccetti's audit assessment of the reasonableness of that significant accounting estimate was seriously deficient. The deficiencies extended to the manner in which procedures were performed and evidential matter was evaluated and the sufficiency of the minimal audit evidence obtained that bore on the part of total sales allowance reserves for which Taro USA did not provide a detailed calculation or explanation. The deficiencies affected what had in the prior year been 45% of the total estimate and rendered illusory the assurance apparently provided by Laccetti's sign-off on Taro USA's 2004 financial information. His violations form a pattern of conduct in the audit in which, as the initial decision observed (I.D. 74), Laccetti appears to have ended up

simply searching for some basis on which to accept the total sales allowance reserves balance, regardless of whether he possessed sufficient competent audit evidence to do so. Such an approach is fundamentally at odds with the role of the independent auditor.

It is clear that Laccetti's conduct adversely impacted investors and the markets. Taro USA's financial results largely drove the performance of its parent company, whose common stock was publicly traded on the NASDAQ National Market and whose consolidated financial statements were reported in SEC filings. Laccetti's conduct resulted in an unjustified audit report on Taro USA that was then used by the principal auditor in issuing an unqualified opinion on the parent company's financial statements. This deprived investors and the public of the protection that a properly performed audit provides, in this instance protection that should have been an obstacle to the parent company filing financial statements that were so substantially misstated.

The sanctions we impose must protect against Laccetti's demonstrated capacity for the conduct at issue here and, contrary to his claim that this case represents mere "disagree[ment] with the judgments [he] made" (R.D. 204 at 27), must encourage more rigorous compliance by him and others with the principles that "an auditor must exercise, not his 'inclination,' but his 'professional judgment' and that judgment must be 'guided by sound' auditing principles, among which are a 'thorough...search for evidential matter,' AU § 326.23, and an 'attitude that includes a questioning mind and a critical assessment of audit evidence,' AU § 230.07" (*McCurdy*, 396 F.3d at 1263).

We cannot assume, as Laccetti essentially asks us to do, that, despite the type of conduct in which he engaged, he poses no continuing risk of harm to those who trust to the reliability of issuer audit reports. He argues that his violations were "isolated to a single component of an overall reserve during a single audit"; that the audit was one of his first as an engagement partner; that he has an "otherwise unblemished professional career as an accountant and auditor"; that he left Ernst & Young for a regional accounting firm, where he is a partner in "the corporate governance and risk management department" and "does not perform public company audits or any audits of financial statements of companies, public or private"; and that he "has not performed a public company audit since the 2004 Taro USA engagement" and has "no intention of doing so in the future." R.D. 204 at 29-30; R.D. 210 at 3-4; R.D. 180 at 6-7.

Laccetti's misconduct was extremely serious. The more serious a violation, the stronger the inference that it will be repeated. *See generally Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004). His point that the violations involved a single assessment in one area of a 2004 audit, rather than multiple audits, areas, or assessments, does not capture the fuller picture. Among other things, the assessment was highly important, it was in a key audit area, it involved a particular need to press the client and insist on a properly informed and rigorous audit evaluation, relating as it did to a sales allowance estimate based on a deficient process and lacking any detailed calculation or specific explanation, and it fell far short of compliance with PCAOB auditing standards.

Although he had only recently been promoted to engagement partner, did not have prior experience leading a pharmaceutical company audit, and faced particular challenges due to Taro USA's lack of a formalized process for estimating sales allowances and difficulty providing information about the estimates, he accepted the role of engagement partner on the audit, was an experienced auditor and had prior experience with the client when he committed the violations, claims to have appreciated and responded to the risks in that audit area, and did not seek assistance from more experienced auditors on the admitted difficulties and problems he encountered in that area. According to Laccetti, he has no track record of auditing public company financial statements since the 2004 audit or of auditing any company's financial statements since March 2009.

Laccetti highlights that he initially expressed to management and the principal auditor an unfavorable view about the level of Taro USA's 2004 sales allowance reserves and requested further support for the amount and that some detailed audit work was done on the individual accounts receivable reserves other than chargebacks. And, according to Laccetti's testimony, he made an effort in the 2004 audit to improve procedures by trying to download information from Taro USA's accounting system onto an audit software tool so that he could "manipulate that information," "create lags," "pull out various accounts" and "look at complete populations of data," but had to "abandon that approach because they just could not provide us the information in readable data for our audit tools." R.D. 139a at 886-88. Those actions appear to reflect an appropriate audit approach, but whether in the larger context here they ultimately redound to Laccetti's credit is a different question. In fact, these indications of his focus on the problem and his apparent competence in recognizing that he needed to do more to address it, make his ultimate acceptance of the total reserves all the more troubling.

Furthermore, as the Division reasons, Laccetti's "current intentions are not enforceable," and his "occupation provides him with ample opportunity to commit future violations, as he remains a CPA, employed by a registered public accounting firm, with many more years of practice ahead of him," at 47 years old. R.D. 215 at 2; see R.D. 180 at 5; R.D. 135 at 192. Previously in his career, he returned to an audit practice after devoting several years to the same kind of work he says he has done since leaving Ernst & Young. R.D. 137 at 660-67. The record does not support a conclusion about the factors and motivations that shaped his career decisions or that would likely affect them if this proceeding were resolved, as he urges, with no more than a "de minimis" sanction. Laccetti has shown no recognition of the wrongful nature of his conduct, and we have no assurance that he would respond differently if faced with similar circumstances in a future issuer audit, both of which he acknowledges are valid factors for us to consider. R.D. 210 at 2; see, e.g., *Horning v. SEC*, 570 F.3d 337, 346 (D.C. Cir. 2009); *Seghers v. SEC*, 548 F.3d 129, 137 (D.C. Cir. 2008); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 100 (2^d Cir. 1978); *Rita J. McConville*, SEC Rel. No. 34-51950, 2005 SEC LEXIS 1538 at *60 (June 30, 2005), *aff'd*, 465 F.3d 780 (7th Cir. 2006). Even if, as Laccetti claims, his "otherwise unblemished professional career" (R.D. 204 at 29 n.38) were a mitigating factor, it is not significantly mitigating overall.

See, e.g., *Siegel v. SEC*, 592 F.3d 147, 156-57 (D.C. Cir. 2010) (“an associated person should not be rewarded for acting in compliance with the securities laws and with his duties as a securities professional”); *Kornman v. SEC*, 592 F.3d 173, 187-88 (D.C. Cir. 2010); *Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006); *Dennis S. Kaminski*, SEC Rel. No. 34-65347, 2011 SEC LEXIS 3225 at *43 & n.35 (Sept. 16, 2011).^{43/}

We have therefore determined to bar Laccetti from association with a registered public accounting firm but to provide that he may petition the Board to associate with such a firm after two years. We have also determined that a civil money penalty is appropriate to further impress on him the seriousness of his violations, which created a significant risk of substantial losses to investors, and deter him, as well as others who may find themselves in similar circumstances, from future such misconduct. Under the circumstances, we impose an \$85,000 civil money penalty. Given the findings and basis on which these sanctions are imposed, they are far from excessive, contrary to Laccetti’s contentions.^{44/} Laccetti committed multiple violations, but this civil penalty is

^{43/} The initial decision did not take the sanctions principles we have discussed properly into account. It also went beyond proper consideration of whether Laccetti’s violations were isolated or recurrent. That is one inquiry, in determining sanctions, into the characteristics of the conduct that is the subject matter of the litigation. It is not a warrant to make broad assumptions, because “the OIP does not allege any deficiencies” in certain “other aspects of the 2004 Taro USA audit” considered by the decision to be “important,” that his conduct in those unrelated other areas “indicates an adherence to PCAOB standards” and then affirmatively to place great weight on those assumptions in evaluating the conduct actually at issue. See, e.g., I.D. 37-38, 61, 114.

^{44/} In opposing sanctions, Laccetti discusses various litigated and settled cases cited by the Division. R.D. 210 at 4-7. The sanctions imposed here are not out of line with those cases or others that might be cited, including litigated Board cases in which the violation was noncooperation with a PCAOB investigation, in each of which the Board imposed a \$75,000 civil money penalty, in addition to a permanent bar, and which did not present the developed record of auditing standard violations, and the particular concerns about investor protection, that are present here. Cf., e.g., *Dearlove*, 2008 SEC LEXIS 223 at *111 & n.120 (citing certain litigated SEC Rule 102(e) cases against auditors involving single-audit violations); *R.E. Bassie & Co.*, SEC Rel. No. 3354, 2012 SEC LEXIS 89 at *44, *47-48 (Jan. 10, 2012) (litigated case of noncooperation with PCAOB investigation); *Kempisty & Co.*, SEC Rel. No. 34-65950, 2011 SEC LEXIS 4396 (Dec. 14, 2011) (settled 102(e) case); *Dohan + Co. CPAs*, SEC Rel. No. 34-63740, 2011 SEC LEXIS 247 (Jan. 20, 2011) (same); *Chaim Schwartzbard, CPA*, SEC Rel. No. 34-53725, 2006 SEC LEXIS 951 (Apr. 26, 2006) (same); *Michael Karlins, CPA*, SEC Rel. No. 34-49997, 2004 SEC LEXIS 1466 (July 9, 2004) (same); *David T. Thomson, CPA, CPA*, SEC Rel. No. 34-49516, 2004 SEC LEXIS 761 (Apr. 1, 2004) (same); *Randall A. Stone, CPA*, PCAOB Rel. No. 105-2014-007 (July 7, 2014)

at the low end of the range of the heightened civil penalties authorized by the Sarbanes-Oxley Act for each violation involving the level of misconduct found here and less than the maximum civil money penalty authorized by the statute for a single violation not even reaching that threshold.^{45/}

(settled auditing standards case); *Ray O. Westergard, CPA*, PCAOB Rel. No. 105-2010-003 (Feb. 17, 2010) (same); *Williams & Webster, P.S.*, PCAOB Rel. No. 105-2007-001 (June 12, 2007) (same). In any event, the appropriate sanctions depend on the facts and circumstances of each specific case and cannot be determined precisely by comparison with other cases involving different circumstances. *Hatfield*, 2013 SEC LEXIS 1954 at *95. Comparisons to settled cases are particularly problematic because “settled cases take into account pragmatic considerations such as the avoidance of time-and-manpower-consuming adversary proceedings” and therefore those “who offer to settle may properly receive lesser sanctions than they otherwise might have.” *Id.* Here, we have made extensive findings about Laccetti’s departures from the standards of care and carefully considered the public interest, based on a full, developed record.

^{45/} Laccetti’s suggestion is unfounded that a civil money penalty may only be imposed where an auditor engages in “fraud, deceit, manipulation, or an intentional disregard of a regulatory requirement,” the auditor is “unjustly enriched as a result of his conduct,” or there is “direct evidence” that “harm occurred or, if so, the extent of the harm” resulting from the violations. R.D. 210 at 3 (internal quotation marks omitted). As support, Laccetti cites a case involving noncooperation with a PCAOB investigation. *Id.* (citing *Larry O’Donnell, CPA, P.C.*, PCAOB File No. 105-2010-002 at 9-10 (Oct. 19, 2010)). In ordering a civil money penalty in that case, the Board considered factors that a statute authorizing the imposition of civil money penalties in proceedings instituted pursuant to certain sections of the Securities Exchange Act of 1934, typically against stockbrokers and investment advisers, stated that the SEC or the appropriate regulatory agency “may consider” (Exchange Act Section 21B, 15 U.S.C. 78u-2).

Those factors, all of which need not be present even in proceedings governed by that statute, include whether the misconduct “involved fraud, deceit, manipulation, or deliberate disregard of a regulatory requirement”; “[t]he harm to other persons resulting either directly or indirectly from” the misconduct; “[t]he extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior”; “[t]he need to deter such person and other persons from committing such” misconduct; and “such other matters as justice may require.” In terms of harm, that statute does not require, even for the highest of the three “tier[s]” of civil penalties it allows, direct evidence of the occurrence and extent of harm but rather that the misconduct “created a significant risk of substantial losses to other persons” (15 U.S.C. 78u-2(b)(3)(B)), which certainly was true here. In auditor noncooperation cases, the Commission has affirmed the Board’s holding that “the absence of fraud or deceit does not...diminish the seriousness” of the misconduct (*Gately & Associates*, SEC Rel. No. 34-62656, 2010 SEC LEXIS 2535 at *50 (Aug. 5, 2010)), and emphasized the

Accordingly, we impose an associational bar, providing that a petition to associate with a registered public accounting firm may be made after two years, and an \$85,000 civil money penalty.^{46/}

B. Sanctions Determinations for Violation of AU § 316.64

Laccetti did not seek review of the initial decision's finding that he violated AU § 316.64 and PCAOB rules due to the lack of a retrospective review of Taro USA's 2004 accounts receivable allowances. AU § 316.64 provides that an auditor "should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year." With "the benefit of hindsight," that procedure "should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates." *Id.* Rule 3101(a)(2), in effect during the 2004 audit, explains that a standard that uses the word "should"—like AU § 316.64—imposes a responsibility that is "presumptively mandatory." This means that failure to discharge that responsibility "is a violation of the relevant standard and Rule 3100" unless the auditor "demonstrates that, in the circumstances, compliance with" that responsibility "was not necessary to achieve the objectives of the standard" and that "alternative actions he or she followed in the circumstances were sufficient to achieve [its] objectives." Rule 3101(a)(2). No such demonstration is at issue in this case. I.D. 77 n.33; *see, e.g.*, R.D. 180a at 217, 218.

The Division argues that Laccetti "skipped" the retrospective review despite knowing that it was presumptively mandatory; that it was specifically planned for the

"flexib[ility]" of Exchange Act Section 21B when used in such cases, identifying multiple additional considerations "not explicitly enumerated" in that statute (*Bassie*, 2012 SEC LEXIS 89 at *46-*47, *50-*51). Furthermore, Sarbanes-Oxley Act Section 105(c), 15 U.S.C. 7215(c), which governs our enforcement actions for violations of PCAOB auditing standards, authorizes civil penalties not only for "intentional or knowing conduct, including reckless conduct," but for "repeated instances of negligent conduct," as well as for conduct not even rising to that level.

^{46/} Even if Laccetti had not acted recklessly, he engaged, at a minimum, in repeated instances of negligent conduct, and the instances were sufficiently numerous and serious that we would determine that the same sanctions are appropriate. *See Hatfield*, 2013 SEC LEXIS 1954 at *97 n.169 ("given the scope of [the auditor's] repeated auditing failures" finding that sanctions were appropriate "regardless of whether [the auditor's] conduct is deemed to be knowing, reckless, or negligent"); *Dearlove*, 2008 SEC LEXIS 223 at *108 (noting that "a negligent auditor can do just as much harm to the Commission's processes as one who acts with an improper motive" and that "under some circumstances, unreasonable conduct is not necessarily a less egregious disciplinary matter than either intentional or reckless conduct") (citation omitted).

audit; and that Ernst & Young, through Laccetti, represented to the principal auditor and, through it, to Taro USA's parent company, that the procedure would be and had been performed. R.D. 205 at 14-15; R.D. 215 at 4. The Division challenges the hearing officer's conclusions—stated without explanation in a short footnote in the initial decision—that the violation was not proven to have “involved reckless conduct, as opposed to mere negligence” and that the sanctions imposed for the other violations “fully remediate Laccetti's misconduct, and, therefore, [the decision] impose[s] no additional sanctions” (I.D. 113 n. 50). R.D. 205 at 14-15; R.D. 215 at 4. Those statements are in tension with the sound reasons stated elsewhere in the initial decision for holding Laccetti liable for not having “confirmed that a retrospective review had been performed, and reviewed the results” (I.D. 77), and, due to commonalities with the other violations found, with the decision's and our discussion of those other violations.

The retrospective review was a presumptively mandatory procedure under AU § 316.64 and PCAOB Rule 3101(a)(2) that would have addressed the same high-risk area and scarcity of information in which the other violations occurred. More specifically, the Internal Control and Fraud Considerations document, approved by Laccetti and provided to the principal auditor, stated that, to address the identified fraud risk relating to biases in significant accounting estimates, the Ernst & Young audit team planned to “[p]erform detail testing and analytical review procedures, including hindsight review, of all significant accounting estimates.” Ex. J-29 at 8. In the full scope conclusion, Laccetti represented to the principal auditor that Ernst & Young had performed a “full scope US GAAP and US GAAS audit” on Taro USA's financial information, understood by all to require an audit conducted in accordance with PCAOB standards. See, e.g., Ex. D-126; Ex. J-2. And, when the principal auditor forwarded to Laccetti for his review a draft Audit Results and Communications presentation to the audit committee of Taro USA's parent company, Laccetti failed to correct the statement in the document that a retrospective review had been performed. Ex. D-266 at 1, 18; Ex. D-116 at 1-2; R.D. 137 at 527-30; see R.D. 180 at 95; R.D. 182 at 33.

As the hearing officer explained in finding the AU § 316.64 violation, “[t]he required retrospective review related to assessment of Taro USA's accounts receivable reserves, by providing information to assist in identifying possible management bias.” I.D. 77. And “[b]oth in planning the audit and in performing the field work, Laccetti recognized serious issues regarding the reliability of Taro USA's reserves.” *Id.* In otherwise imposing sanctions, the decision explained that Laccetti “did not fail to uncover a latent issue or misapply auditing or accounting standards—conduct that might be described as merely negligent. Rather, from the outset of the audit, [his] attention was specifically directed to the risk of a misstatement of Taro USA's reserves, and he planned the audit accordingly.” *Id.* at 110. As to the other violations found, the decision concluded that Laccetti “must have known that his acceptance of the chargebacks reserve and total reserves including chargebacks,” in spite of inadequate audit testing, “presented a danger to investors and the market.” *Id.* at 112. The decision does not explain why that conclusion would not also apply to the failure to

perform the retrospective review procedure. Indeed, the retrospective review, although “not intended to call into question the auditor’s professional judgments made in the prior year that were based on information available at the time” (AU § 316.64), could have provided important information, not available to the 2003 audit team, about the 2003 year-end sales allowance reserves, some 45% of which (the chargebacks portion, see Ex. L-22 at 2) lacked any detailed calculation or explanation from Taro USA, and which reserves Laccetti used as a reasonable expectation for the 2004 year-end reserves.

Nor is the explanation apparent from the circumstances of the 2004 Taro USA audit, which would only seem to have magnified the importance of the retrospective review. Specifically, as Laccetti knew from the principal auditor’s management letter for 2003 to Taro’s audit committee, Taro USA’s parent company did not “have a formalized process and methodology for the establishment and maintenance of the significant financial statement accounts,” including “accounts receivable reserves (allowances and accruals),” and, “[g]iven the potential importance for financial reporting purposes, formalizing policies and procedures related to these processes” would “provide consistent application from period to period.” Ex. D-21 at 3. During the 2004 first-quarter review, Laccetti made reference to a “[n]eed to build ‘look back’ procedures into [the] A/R allowance process.” Ex. D-24; R.D. 135 at 294-295.

In audit planning documents for the 2004 Taro USA audit, Laccetti identified “[m]anipulating significant accounting estimates,” including “accounts receivable allowances,” as one of three fraud risks; observed that Taro USA was subject to significant pricing pressures and low margins relating to generic pharmaceuticals that creates pressure to meet sales goals and “could lead to improper revenue recognition”; noted that its “accounts receivable allowance estimation process...still remains an area of significant subjectivity”; and developed three audit responses to the risk of management bias in Taro USA’s significant accounting estimates: “[p]erform detail testing and analytical review procedures, including hindsight review, of all significant accounting estimates”; “[d]ocument our understanding of the client’s processes and determine whether there appears to be any management bias”; and “[d]etermine whether management is consistently recording estimates.” Ex. J-29 at 6, 8. Taro USA faced significant financial pressure in 2004, as it tried to help overcome “a substantial decrease” in the parent company’s consolidated second quarter sales, from \$84 million to \$49 million, resulting in an \$8.9 million loss, drop in the share price from around \$60 to \$20, and “several class action lawsuits”; as Taro USA’s recorded net sales for the year “decreased approximately \$35 million to \$248 million”; and as it recorded a net loss of \$33 million, down from \$11 million in net income in 2003, and its “pre-tax net loss before taxes exceeded \$52 million for 2004.” Ex. J-26 at 3; Ex. D-125 at 1-2.

In the field, the audit team had difficulty obtaining information about the sales allowance estimates. Laccetti repeatedly expressed concerns about them. Taro USA did not specifically calculate or explain its chargebacks reserve, impacting at least the first two of Laccetti’s three chosen audit responses to the risk of bias in the accounts

receivable allowances. He abandoned his plan to directly test the chargebacks estimate, which was inconsistent with other financial data he was able to confirm. He stated at the time that “[o]ur accounts receivable analysis is not favorable” and that “we are not comfortable that the accounts receivable are fairly stated as currently presented.” Ex. D-87 at 1. This “meant not hitting the original fieldwork completion date” and having to “expand[] our procedures to perform detailed substantive tests of individual accounts receivable to gain comfort that the amounts were properly recorded at net realizable value.” Ex. J-9 at 5; R.D. 180 at 87. And when the principal auditor’s engagement partner first questioned Laccetti about Laccetti’s conclusion that the year-end accounts receivable reserves were reasonable, Laccetti responded with hesitation.

Moreover, Laccetti has claimed that during the 2004 audit he “wanted as much documentation and information as possible relating to Taro US’s process for determining accounts receivable as a whole,” sought “to extract as much data from Taro US as possible,” and approached the adequacy of its total accounts receivable reserve based on “an assessment of the totality of evidence gathered over the course of the audit.” R.D. 180 at 32; R.D. 180a at 61-62; R.D. 204 at 6 (emphasis in original). Yet the 2004 audit did not include a retrospective review of the sales allowance estimates.

Laccetti takes up this issue in his opposition brief on appeal, contending that “there is no evidence to suggest” that his AU § 316.64 violation was reckless and no need for “additional sanctions” because the “other imposed sanctions ‘fully remediate [his] misconduct.’” R.D. 210 at 7-8 (quoting initial decision). He does not argue that the retrospective review could not be performed or that the procedure would not have been meaningful. Having stated in his answer to the OIP that, “to the best of [his] current knowledge, no such procedures [as a retrospective review] were performed” (R.D. 10 at 7), and testified at the hearing that he did not recall the review being done or documented in the audit (R.D. 135 at 383-95), he seems to reason on appeal that he could have thought that a retrospective review was done, even though that was not so, or that it is a matter of little consequence for sanctions purposes, due to other audit information he claims to have obtained about possible management bias.

In support of his position, Laccetti first cites a work paper captioned “Gross/Net Sales and Cash collection analysis, 12/31/2004.” R.D. 210 at 7 (citing Ex. L-22 at 12). He argues that the “lag analysis” on that page was used to “compare the 2003 accounts receivable reserve to the subsequent collection of cash in 2004 related to 2003 sales,” thereby resembling a retrospective review. *Id.* In finding the AU § 316.64 violation despite a similar argument, the initial decision noted that there was no supporting evidence that this other procedure was considered to be a retrospective review. I.D. 76. As the work paper itself, the email from the senior manager transmitting the lag analysis to Laccetti, and Laccetti’s hearing testimony all indicate, the purpose of the analysis was to compute an amount of net accounts receivable “collected” in, and “still open” after, each quarter in 2004, “using the assumption that it takes 110 days to collect the average receivable,” to support a management representation that there was a “slow

down" in payments by Taro USA's three largest wholesalers. Ex. L-22 at 12; Ex. D-82 at 1, 6; R.D. 135 at 386-95. The analysis "basically shows that there is still \$48 million in outstanding receivables as of December 31, 2004 that do not relate to the current quarter (older receivables)," up from \$41 million in the first quarter and \$39 million in the third quarter. Ex. D-82 at 1, 6 (senior manager's email); Ex. L-22 at 12. Even if, for that general purpose, using the imprecise 110-day assumption based on 2003's much faster pace of cash collections were justifiable, there is no indication that Laccetti considered whether it would have captured Taro USA's actual 2004 sales allowance claims experience well enough to serve as a retrospective review of the year-end 2003 reserves. The lag analysis work paper does not present, summarize, or analyze data in a way that serves the purpose of evaluating accounts receivable reserves for potential management bias. The lag analysis does not mitigate the AU § 316.64 violation.

Second, Laccetti asserts that the "analytical procedure comparing cash collections as a percentage of gross sales to net sales as a percentage of gross sales" for 2003 and 2004 (see Ex. L-22 at 1640)—on which he claims to have relied to test the reasonableness of the year-end sales allowance reserves under AU § 342—gave him "comfort" that Taro USA was "doing a good job estimating allowances, as well as it didn't appear there were any biases." R.D. 210 at 7-8 (quoting his testimony). For the reasons discussed above, that audit work was too cursory to give any significant comfort that Taro USA was doing a good job estimating the allowances. Moreover, Laccetti has made clear he "is not asserting that" this work "is satisfying AU § 316.64." R.D. 180a at 218. Indeed, he does not cite anything in the work papers that purports to "demonstrate[] that alternative actions [the audit team] followed in the circumstances were sufficient to achieve the objectives of" AU § 316.64, which would have been required under Rule 3101(a)(2), had anyone believed that to be the case. See I.D. 77 n.33. The work papers do not suggest that the procedure he cites, which is not discussed in any of the summary memoranda, was done to assess management bias. Simply performing some other procedure would not provide a basis for thinking that the retrospective review was unimportant. PCAOB standards envision that auditors will do other procedures to assess potential bias in management estimates in addition to a retrospective review. See, e.g., AU §§ 312.36 (quoted in 342.14), 342.04, 342.09.

Finally, Laccetti argues that the senior manager "signed off on the team's summary of procedures performed indicating that a retrospective review had been performed" and that, as the audit partner, Laccetti "is entitled to rely on those preparing and initially reviewing the working paper" and is "not expected to recalculate amounts or replicate procedures." R.D. 210 at 7, 8 n.4, citing Ex. L-103 at 11 and quoting Ex. L-179 at 43 n. 142 (his expert's report). Again, the initial decision persuasively rejected the basis for this argument: "Although [the senior manager] initialed the checklist, he did not cite any work papers evidencing the retrospective review, and Laccetti has not identified any work paper that actually purports to be the retrospective analysis required by AU § 316.64." What is at issue is not "recalculat[ing]" or "replicat[ing]" an analysis; the issue is, as the initial decision correctly framed it in discussing the violation,

“confirm[ing] that a retrospective review had been performed, and review[ing] the results,” under circumstances that magnified the procedure’s importance. I.D. 77.

We conclude that the lack of the retrospective review was part of the reckless or, at a minimum, repeatedly negligent, course of conduct in which Laccetti engaged in assessing Taro USA’s 2004 sales allowance estimates. Under the circumstances of this case, however, in which the clear gravamen of the conduct is addressed by the violations we have found and the sanctions we have imposed above, we do not impose additional sanctions for the AU § 316.64 violation. But, while not necessary to our determination of the sanctions we impose, this violation does reinforce the appropriateness of those sanctions.

IX.

As set forth above, we have found that the Division proved by a preponderance of the evidence that Laccetti violated PCAOB rules and auditing standards, and we have determined appropriate sanctions for those violations.

An appropriate order will issue. ^{47/}

By the Board (Board Member Ferguson
not participating)

^{47/} We have considered all of the parties’ contentions regarding the issues addressed in this opinion and we have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

THE UNIVERSITY OF CHICAGO

PHYSICS DEPARTMENT

PHYSICS 351

PHYSICS 351



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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In the Matter of Mark E. Laccetti, CPA,
Respondent

PCAOB File No. 105-2009-007

ORDER IMPOSING SANCTIONS

January 26, 2015

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

ORDERED that Mark E. Laccetti is barred from associating with any registered public accounting firm, provided that, after two (2) years, he may petition for Board consent to associate with a registered public accounting firm; and it is further

ORDERED that Mark E. Laccetti shall pay a civil money penalty in the amount of \$85,000 by (a) United States postal money order, certified check, bank cashier's check or bank money order, (b) made payable to Public Company Accounting Oversight Board, (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006 within 30 days after the effective date, described below, and (d) submitted under a cover letter which identifies the payer as a respondent in these proceedings, sets forth the title and PCAOB File Number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: Phoebe W. Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

Effective Date of Sanctions: If Respondent does not file an application for review by the Securities and Exchange Commission (Commission) and the Commission does not order review of the sanction on its own motion, the effective date of the sanction shall be the later of the expiration of the time period for filing an application for Commission review or the expiration of the time period for the Commission to order review. If Respondent files an application for review by the Commission or the Commission orders review of the sanction, the effective date of the sanction shall be the

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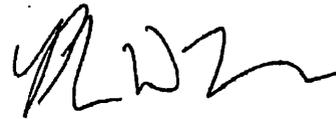
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date the Commission lifts the stay imposed by Section 105(e) of the Sarbanes-Oxley Act of 2002.

By the Board (Board Member
Ferguson not participating).



Phoebe W. Brown
Secretary

January 26, 2015

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