

**PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD**

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	)	PCAOB File No. 105-2009-003
<i>In the Matter of S.W. Hatfield, CPA</i>	)	
<i>and Scott W. Hatfield, CPA</i>	)	
	)	<b>FINAL DECISION</b>
	)	
Respondents	)	
	)	February 8, 2012
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**Appearances**

Michael Plotnick, Esq., and Phillip J. Berkowitz, Esq., Washington, DC, for the Division of Enforcement and Investigations.

John A. Koepke, Jackson Walker LLP, Dallas, TX, for Respondents.

**I.**

S.W. Hatfield, C.P.A. (the "Firm"), a registered public accounting firm, and Scott W. Hatfield ("Hatfield") appeal from a hearing officer's decision revoking the Firm's registration with the Board, with a right to reapply after three years; barring Hatfield from association with any registered public accounting firm, with a right to petition to terminate the bar after three years; and imposing a civil money penalty of \$50,000 jointly and severally on Hatfield and the Firm (collectively, "Respondents"). The hearing officer issued his decision after holding a hearing and finding that Respondents violated PCAOB Rules 3100 and 3200T in several respects in connection with their audits of two public companies. We base our findings on a *de novo* review of the record, except as to those findings not challenged on appeal. Like the hearing officer, we find that Respondents violated Rules 3100 and 3200T. Because of that conduct, we permanently revoke the Firm's registration and permanently bar Hatfield from association with a registered public accounting firm.

**II.**

The Firm is a public accounting firm organized as a sole proprietorship and licensed under Texas law to engage in the practice of public accounting. The Firm is registered with the PCAOB pursuant to Section 102 of the Act and PCAOB rules. Hatfield, the Firm's sole owner and employee, is a certified public accountant licensed in Texas. At all relevant times Hatfield has been a person associated with a registered public accounting firm, as defined in Section 2(a)(9) of the Act and PCAOB rules.

On January 9, 2009, the Board issued an Order Instituting Disciplinary Proceedings alleging that Respondents violated PCAOB rules and auditing standards in connection with their audits of the 2004 and 2005 financial statements of Epicus Communications Group, Inc. ("Epicus"), and the 2003 financial statements of Bidville, Inc. ("Bidville"). Respondents filed an Answer on February 16, 2009. A hearing was held on July 28 and 29, 2009, and the hearing officer issued his decision on December 16, 2009. Respondents petitioned for review. Briefing concluded on May 18, 2010, and oral argument before the Board was held on July 27, 2010.

## **A. The Epicus Audits**

During the relevant period, Epicus was a Florida corporation, the common stock of which was registered with the Securities and Exchange Commission ("SEC") and quoted on the OTC Bulletin Board and the Pink Sheets. Epicus was an issuer, as defined in Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii). Epicus was a holding company and during the relevant period its only active business was the resale of telecommunication services through a subsidiary. Respondents were Epicus's auditors from 2002 through 2007, and, as is relevant to this proceeding, issued unqualified audit opinions on Epicus's financial statements for fiscal years 2004 and 2005. The audit reports containing those opinions were filed with the SEC in Epicus's annual Forms 10-KSB for 2004 and 2005.

### **1. FY 2004 Revenue Recognition**

#### Facts

In FY 2004, Epicus offered three types of telephone service: local, which was billed monthly in advance of service, on a flat-rate basis; long distance, which was billed monthly after service was provided, based on calls made; and bundled, combining unlimited local and long distance service, which was billed monthly in advance of service, on a flat rate basis. Epicus's combined reported revenue for FY 2004 was approximately \$25 million.

During the audit of Epicus's FY 2003 financial statements, which are not at issue here, Respondents determined, and notified Epicus, that its revenue recognition policy did not comport with GAAP. Respondents determined that GAAP required Epicus to recognize the income from telephone services at the time they were provided to its customers. Instead, Epicus recognized revenue when it billed its services to customers, which was before local and bundled services were provided, and after long distance service was provided.

Respondents recommended that Epicus change its policy to conform with GAAP by recognizing revenue for local and bundled services over each customer's billing period on a per-day basis, as the revenue was earned, and recognizing revenue for

long distance service when it was provided. At the time of their audit of Epicus's FY 2004 financial statements, however, Respondents knew that Epicus had not changed its revenue recognition policy.

The OIP alleged that in their audit of Epicus's FY 2004 financial statements, Respondents failed to evaluate whether Epicus's revenue recognition policy caused its financial statements to be materially misstated under GAAP. At the hearing, Hatfield acknowledged that Respondents' work papers do not include any indication that they performed such an evaluation, but he testified that, in fact, during the audit he "did a visual and mental check," and "kind of just rough in [his] mind [he] looked to see where the difference was." Based on this, he "did not believe at that time that [Epicus's policy] would significantly misstate or distort the financial statements."

Also at the hearing, Respondent offered the testimony of an expert who attempted to duplicate Hatfield's claimed "visual and mental check." Respondents' expert created a written analysis that he described as "what a work paper, if required, might have looked like to assure the experienced auditor that there was not a material difference by not having the revenue recognition technically in accordance with GAAP." The analysis included detailed calculations purporting to quantify the maximum amount of the misstatement attributable to Epicus's non-GAAP policy, an amount that exceeded the planning materiality and tolerable misstatement thresholds that Respondents had set for the audit. In spite of this, the expert stated that, in his opinion, the misstatement amount he had calculated would not have been material. He based his opinion on a materiality evaluation that calculated the effect of the misstatement on Epicus's reported earnings per share—a different materiality analysis than that used by Respondents in the work papers.

The expert's written analysis, however, was incomplete and relied on unsupported assumptions. In calculating the maximum amount of the potential misstatement, he considered only Epicus's revenue for local service, ignoring Epicus's revenues for bundled and long distance services. Furthermore, the expert's calculations assumed that the amount of Epicus's monthly billings remained constant throughout FY 2004, when in fact they increased substantially over the year, and that Epicus sent bills to its customers throughout each month, when, according to Respondents' work papers, Epicus sent 80% of its bills to customers during the last three days of the month. If the expert had taken these factors into account, his calculations would have been even more complex, and would have led to a different, higher misstatement amount. Both the expert and Hatfield stated that they could not estimate what that amount would be.

### Analysis

AU § 150.02 and AU § 230 of the Board's interim auditing standards required Respondents to exercise due care in the performance of the Epicus audit. Respondents were required "to plan and perform the audit to obtain reasonable

assurance about whether the financial statements [were] free of material misstatement, whether caused by error or fraud."<sup>1/</sup> Respondents knew that Epicus's FY 2004 financial statements contained a misstatement attributable to its non-GAAP revenue recognition policy. They were required, therefore, to obtain reasonable assurance that that misstatement did not cause the financial statements to be materially misstated.

Before the Board, Respondents argue, as they testified at the hearing, that they evaluated materiality by performing a "mental check and sight analysis." While they concede that the misstatement resulting from the non-GAAP accounting exceeded the "quantitative materiality threshold," they argue that "qualitatively the GAAP departure was not material." The hearing officer noted that Hatfield appeared uncertain and unconvinced of his own claim that he conducted a materiality evaluation and concluded that his demeanor strongly suggested that his testimony in that regard was fabricated.

Respondents have provided no basis for the Board to revisit the issue of Mr. Hatfield's demeanor at the hearing. In addition, the record provides ample reason not to credit Hatfield's testimony on this point. Prior to the hearing, Hatfield never claimed to have conducted a mental check and sight analysis, even though he had ample opportunity and motive to do so. In fact, during the investigation of this matter he testified that he could not recall having conducted any materiality analysis; that, if he had done so, he would have expected to find it reflected in the work papers; and that the absence of a work paper indicated that "there was nothing available for me to do." And when Respondents replied to the Division's notice that it intended to recommend that the Board issue an OIP alleging, among other things, that Respondents had failed to conduct a materiality evaluation, Respondents did not claim that Hatfield had conducted a materiality evaluation. Instead, they asserted that Epicus's management could not provide the information required to do so. Finally, Hatfield has never—not at the hearing and not in his briefs before the Board—offered any credible description of the "visual and mental check" or explained in any coherent manner how he concluded that Epicus's GAAP departure was not material.

We conclude that, even if Hatfield performed a "mental check and sight analysis" of whether Epicus's GAAP departure caused its financial statements to be materially misstated it was not sufficient to comply with our standards. Respondents' own expert admitted that the hypothetical work paper he created to demonstrate the kind of evaluation Hatfield claimed to have performed resulted in an amount that exceeded Respondents' materiality and tolerable misstatement amounts. Had Respondents truly performed any sort of meaningful materiality analysis, and had that analysis returned a result in excess of the materiality and tolerable misstatement amounts that Respondents had set in planning, Respondents could not simply have "considered the

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<sup>1/</sup> AU § 110.02.

context of Epicus [sic] financial condition and performance," decided that the misstatement was not qualitatively material, and continued on with the audit.<sup>2/</sup>

## **2. Confirmation of FY 2004 Accounts Receivable**

### Facts

In its FY 2004 financial statements, Epicus reported year-end accounts receivable totaling approximately \$5.7 million, net of an allowance for doubtful accounts of \$1.5 million. This represented approximately 75% of Epicus's reported year-end assets. Epicus classified its accounts receivable as relating either to amounts due from residential or commercial customers for telephone service, or to carrier access fees due from the telecommunications companies whose services Epicus resold. Residential and commercial customers were further subdivided into active and inactive accounts. All service to inactive accounts had been terminated and Epicus assigned the receivables due from those accounts for collection, either by Epicus's in-house staff or outside collection agencies.

Epicus's receivables included approximately \$3.1 million due from active accounts; \$1.5 million due in carrier access fees; and \$2.6 million due from inactive accounts, approximately \$1 million of which had been assigned to outside agencies for collection. Respondents did not send confirmation requests to any of Epicus's active customers to confirm the existence of active accounts receivable, to any telecommunications companies to confirm carrier access fee receivables, or for any inactive accounts.

### Analysis

AU § 330.34 of the Board's interim auditing standards provides that "[c]onfirmation of accounts receivable is a generally accepted auditing procedure," and that because "it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity . . . there is a presumption that the auditor will request the confirmation of accounts receivable during an audit . . . ." Respondents' work papers indicate that they decided not to send positive confirmations because there were a "[l]arge number of small accounts with little possibility of accurate response," and because "[t]he use of positive audit confirmations is not practical due to the existence of approximately 40,000 separate accounts with no single account or group of accounts being significant within the population. Accordingly the confirmation response rate would not be cost effective."

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<sup>2/</sup> Aside from their arguments that "there was no impact on earnings per share" and that Epicus had reported losses and negative cash burn, Respondents have offered no explanation of how they determined that the misstatement was not qualitatively material.

In addition, Hatfield testified that one of his reasons for not sending confirmation requests was "so that time can be saved by opting out of the positive confirmation process."

Respondents argue that in the Epicus audit they made an allowable determination not to send confirmation requests under AU § 330.34, which provides that an auditor might elect not to send confirmation requests if the auditor determined that "[t]he use of confirmations would be ineffective." Under AU § 330.23:

In determining the effectiveness and efficiency of employing confirmation procedures, the auditor may consider information from prior years' audits or audits of similar entities. This information includes response rates, knowledge of misstatements identified during prior years' audits, and any knowledge of inaccurate information on returned confirmations. For example, if the auditor has experienced poor response rates to properly designed confirmation requests in prior audits, the auditor may instead consider obtaining audit evidence from other sources.

Respondents had no relevant information from prior Epicus audits as to the utility of confirmations because they had never sent confirmation requests to Epicus's customers in their prior audits. Respondents' work papers do not cite any audits of similar entities to support their conclusion that sending confirmation requests to Epicus's customers would be ineffective,<sup>3/</sup> but, at the hearing, Hatfield testified that he relied on his prior experience while participating in fifteen audits during the 1970s and 1980s. Respondents argue that those audits provide support for Respondents' conclusion that sending confirmation requests to Epicus's customers would be ineffective.

Whatever the merits of Respondents' "too many small accounts" justification as it relates to the active accounts,, it clearly had no application to the carrier access fee receivables, as Respondents' own expert admitted at the hearing. Epicus's accounts receivable included approximately \$1.5 million for carrier access fees, most of which were claimed due from just four of the 20 companies. Yet Respondents did not send confirmation requests to any of the companies to confirm the existence of these receivables. Respondents' failure to send confirmations to these companies was particularly significant because, during FY 2005, Epicus's management discovered that a former executive had directed employees to make false entries in Epicus's computerized customer accounts records, which, they concluded, led to an overstatement of Epicus's carrier access fee receivables. If Respondents had sent requests to confirm the carrier access fee receivables in their audit, they might have

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<sup>3/</sup> AU § 330.35 directed that "[a]n auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame th[e] presumption [in favor of sending confirmations]."

discovered the overstated carrier access fee receivables, which would have alerted Epicus's management to the possible fraud and overstatement at an earlier date.

Respondents argue that "carrier access fee receivables were a creation of federal statute," and that "this validates and confirms the existence of the receivable." This is simply incorrect. Indeed, even Respondents' own work papers indicated only that they believed the "collectability" of the carrier access fee receivables, not their existence, was "relatively assured by statute as long as the carrier in question remains solvent and operating." Similarly, at the hearing, Hatfield contended that the telecommunications companies' statutory obligation to pay carrier access fees supported the collectability of the receivables, not their existence.<sup>4/</sup>

Respondents are similarly unable to explain their failure to confirm approximately \$1 million dollars in inactive accounts receivables assigned to collection agencies. At the hearing, Hatfield claimed he did not attempt to confirm inactive account receivables because "we accounted for those in the allowance for bad debt calculation." An allowance calculation, however, is not a substitute for confirmation of the existence of the receivable. Moreover, in calculating an allowance for Epicus, Respondents assumed that Epicus would collect 40% of the inactive account receivables it had assigned for collection, even though Respondents had done nothing to confirm the existence of those receivables.

Respondents argue that "the placement of an existing receivable with a collection agency and the confirmation of that event does provide reliability as to the continuing existence and collectability, if limited and recognized by the offsetting allowance of the receivable." Respondents, however, never confirmed that the \$1 million in inactive account receivables were, in fact, "existing receivables." And whatever the placement of an "existing receivable" may say about that receivable's "continuing existence," mere placement of a receivable with a collection agency provides no reliability about the receivable's existence in the first instance.<sup>5/</sup>

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<sup>4/</sup> Respondents also argue that the fact that they were unable to obtain information from Bell South about the existence of certain carrier access fees demonstrates that attempting to confirm carrier access fee receivables would have been ineffective. But this occurred after the FY 2004 audit, and therefore is not relevant to the sufficiency of that audit.

<sup>5/</sup> AU § 330 includes no exception to the confirmation requirement for receivables assigned for collection, nor would there be any logical reason to assume the existence of a receivable merely because the company's records indicated that it had been assigned to a collection agency.

### **3. Alternative Procedures to Test FY 2004 Accounts Receivable**

#### Facts

Though they did not send any confirmation requests, Respondents contend that they employed adequate alternative procedures to test the existence of Epicus's accounts receivable by reviewing Epicus's cash receipts during a 53-day period following the close of FY 2004. In conducting that review, Respondents did not attempt to match Epicus's receipts with the actual items being paid. Instead, they accepted certain representations from Epicus concerning the firm's historic experience regarding the timing of receivable payments, without testing the validity of those representations. Respondents used those untested representations to determine, "looking at the broad picture," how much of the cash that Epicus received during the 53-day period related to Epicus's year-end accounts receivable balances.

Using this methodology, Respondents concluded that a total of approximately \$2.3 million in cash received during the period related to payments on active year-end residential and commercial receivables, which totaled \$3.1 million. Respondents did nothing to test the existence of the remaining \$800,000, even though that amount substantially exceeded their planning materiality and tolerable misstatement thresholds for the audit. Similarly, Respondents concluded that approximately \$0.7 million in cash collected during the period was attributable to payments on carrier access receivables, which totaled \$1.5 million, but did nothing to verify the existence of the remaining \$0.8 million, even though, again, that amount substantially exceeded Respondents' planning materiality and tolerable misstatement thresholds. Finally, Respondents did not attribute any of Epicus's cash receipts during the period to the approximately \$2.6 million in receivables for inactive accounts reflected in Epicus's FY 2004 financial statements, including both those retained for in-house collection and those referred to outside collection agencies, yet they did not employ any alternative procedures to test the existence of those receivables.

#### Analysis

AU § 330 of the Board's interim auditing standards requires auditors to use alternative procedures to test the existence of accounts receivable that were not confirmed through a confirmation process. Under those standards, "alternative procedures may include examination of subsequent cash receipts (including matching such receipts with the actual items being paid) . . . ."<sup>6/</sup> Regardless of the specific procedures employed, however, PCAOB interim auditing standards required

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<sup>6/</sup> AU § 330.32.

Respondents to use due professional care, obtain sufficient competent evidential matter, and exercise professional skepticism in all aspects of their audit.<sup>7/</sup>

Respondents argue that they tested the accounts receivable for both existence and validity. Respondents explain that "inactive" accounts were not tested because they were being pursued by internal and external collections, and thus, they contend, their existence could be assumed. Respondents maintain that "confirmation of the amounts in collection for inactive accounts was taken into account in the allowance for bad debt calculation." Respondents argue that they "use[d] a subsequent cash collection method to verify the existence and amount of active accounts receivable," and that "Respondents [sic] testing of accounts receivable for the balances due on active and inactive receivables demonstrated that management's reports were reliable."

With respect to active account receivables and carrier access fees, Respondents' examination of subsequent cash receipts did not meet the requirements of PCAOB standards. Respondents did not attempt to match cash receipts with the accounts being paid. Rather, Respondents simply considered Epicus's total claimed receivables and the total cash received, and applied untested assumptions provided by the company. Even so, Respondents were only able to confirm the existence of a portion of the claimed receivables, but did nothing at all to test the existence of the balance. And Respondents performed no alternative procedures whatsoever to test the existence of the claimed receivables for inactive accounts. As noted above, placement of a receivable with a collection agency tells the auditor nothing about whether that receivable exists.

#### **4. Value of FY 2004 Accounts Receivable**

##### Facts

As discussed above, Epicus carried its accounts receivable on its FY 2004 financial statements net of a \$1.5 million allowance for doubtful accounts. Hatfield acknowledged that as part of Respondents' audit procedures they were required to test this allowance, and he purported to do that in Respondents' work papers.

Hatfield testified that, in performing his test, he did not use the company's methodology for calculating the allowance. In fact, during his investigative testimony, he stated: "The company's protocols for analysis on the accounts receivable was a flat per month charged to bad debt expense . . . based on a number that was pulled out of the air."

Therefore, Hatfield performed his own calculations to determine the allowance that should be reflected in Epicus's financial statements. In his calculations, he

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<sup>7/</sup> AU §§ 150, 230, 326.

considered only Epicus's receivables for active and inactive accounts. He assumed that no allowance was needed for carrier access fee receivables, because the telecommunications companies had a legal obligation to pay the fees, even though he had not tested the existence of those receivables.

In calculating an appropriate allowance for active account receivables, Respondents accepted, without requiring any supporting evidence, Epicus's representation that 90% of its active accounts receivable were paid within 90 days. Respondents' work papers indicate that, based on this representation, they intended to take "an arbitrary 10% of the active [accounts receivable] . . . for estimated uncollectible accounts," or approximately \$310,000. Instead of employing this methodology, Hatfield used Epicus's receivables aging report to estimate that the company had approximately \$1.1 million in past due active accounts receivable, even though Respondents' work papers state that "[t]he Company has no workable aging reports." Hatfield then calculated an allowance of 10% of that figure, or approximately \$110,000. Hatfield admitted that this approach was not in accordance with the work papers, and that the allowance for active account receivables "should have been 10 percent of three million one instead of one million one . . . ."

In calculating an allowance for Epicus's inactive account receivables, Hatfield assumed that Epicus would collect 50% of the receivables assigned for in-house collection and 40% of the receivables assigned to outside collection agencies. He based those assumptions on his own experience in various contexts over the years, not on any information provided by Epicus concerning its historical experience in collecting accounts receivable, and he did not test the validity of his assumptions in terms of Epicus's actual experience. For in-house collections, the 50% assumption was simply what Hatfield "anticipated the best case scenario for collections on that bracket of receivables would be"; he admitted that the "[w]orst case [scenario] would be zero." For outside agency collections, his assumption was based on his view that "[o]utside collection agencies have a relatively weak history . . . ."

### Analysis

PCAOB standards required Respondents to exercise due professional care in performing audit procedures to test Epicus's allowance for doubtful accounts.<sup>8/</sup> Respondents argue that the method that they used to do so, which, they claim, included conducting a risk assessment and interviewing appropriate company personnel, was sufficient.<sup>9/</sup> Respondents note that there is no evidence in the record that the allowance

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<sup>8/</sup> AU § 230.

<sup>9/</sup> Respondents' briefs before the Board also assert that they "tested management's representations and found such to be reasonable." But that assertion is

for doubtful accounts was misstated or that the financial statements were not fairly presented in this regard.

Respondents' arguments do not address the facts that, in calculating an allowance for Epicus's active accounts, they failed to follow their own methodology, and, as a result arrived at an allowance that was only about one-third the amount that their own methodology should have yielded. The difference, approximately \$200,000, was more than the tolerable misstatement amount that Respondents had established for the audit. Whether or not the allowance or the financial statements were ultimately found to be misstated is not relevant to the adequacy of the procedures performed during the audit. With regard to the allowance for active accounts receivable, Respondents failed to exercise due professional care.

Moreover, with regard to inactive receivables, Respondents obtained no competent evidential matter whatsoever. Respondents assumed the collection of a portion of receivables, the existence of which they had not verified, and used assumptions based on Hatfield's unrelated prior experience, without making any effort to determine whether those assumptions had any application to Epicus's actual historical experience. Accordingly, Respondents also failed to comply with the Board's requirement to obtain sufficient competent evidential matter to afford a reasonable basis for the opinion.<sup>10/</sup>

## **5. FY 2005 Revenue Recognition**

### Facts

In October 2004, during Epicus's FY 2005, Epicus filed for Chapter 11 bankruptcy. The company remained in operation, and its 2005 financial statements, as audited by Respondents, reported total revenue of \$18,775,796. Epicus changed its revenue recognition policy in calculating its revenue for its FY 2005 financial statements, and included a description of its policy in its Form 10-KSB for FY 2005 filed with the SEC:

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

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unsupported in the brief, and we can find no evidence in the record that would support it. Accordingly, we give it no weight here.

<sup>10/</sup> AU § 326.

This disclosure was incomplete, because it did not disclose that Epicus had changed its policy, and it was incorrect, in part, because the Form 10-KSB included Epicus's FY 2004 financial statements, as to which, as discussed above, Epicus employed a different revenue recognition policy that was not in accordance with generally accepted accounting principles. In addition, the nature and effect of the change in policy was not disclosed.

### Analysis

At the time of Respondents' audit of Epicus's FY 2005 financial statements, AU § 420 of the PCAOB's interim auditing standards provided that an audit report should identify those circumstances in which accounting principles were not applied consistently in the current period in relation to the preceding period. It explained:

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

Because Epicus used a revenue recognition policy that was not in accordance with generally accepted accounting principles in FY 2004, any change to that policy should have been accounted for as a correction of an error by restating one or more prior periods, if the effect was material. Moreover, because Epicus did not apply the same revenue recognition policy in FY 2005 that it had used in FY 2004, AU § 420 required Respondents to evaluate whether the change had a material effect on the comparability of Epicus's FY 2004 and FY 2005 financial statements.

There is no indication in Respondents' work papers that they conducted such an evaluation, and in his investigative testimony Hatfield acknowledged that he was not sure he had even considered that issue. Nevertheless, Respondents did not address in their audit report Epicus's inconsistent revenue recognition policies as reflected in the FY 2004 and FY 2005 financial statements covered by the audit report.

Before the Board, Respondents argue, for the first time, that they were not required to apply AU § 420. Respondents' argument appears to be that as of the date of their FY 2005 audit report, Epicus management planned to adopt fresh start accounting pursuant to AICPA Statement of Position 90-7 ("SOP 90-7"). SOP 90-7 states that "fresh start financial statements prepared by entities emerging from bankruptcy will not be comparable with those prepared before their plans were confirmed because they are, in fact, those of a new entity." Respondents argue that

"[f]resh start financial statements do not need to compare change in accounting policy or the material effect thereof."

By its terms, however, SOP 90-7 does not allow fresh start accounting to begin until the entity's reorganization plan is confirmed by the bankruptcy court. Respondents' brief notes that this did not happen until December 8, 2005, which was after the date of their audit report on Epicus's FY 2005 financial statements.<sup>11/</sup> While Respondents concede that December 8, 2005 was the date Epicus adopted fresh start accounting "for accounting purposes," they appear to argue that AU § 560, which governs the auditor's response to subsequent events, relieved them of their obligation to consider the comparability of Epicus's FY 2004 and 2005 financial statements. Their argument appears to be that because Epicus management expected fresh start accounting to commence sometime after the FY 2005 audit report was issued, they changed the accounting policy early because AU § 560.03 says that "[a]ll information that becomes available prior to the issuance of the financial statements should be used by management in its evaluations of the conditions on which the estimates were based."

Respondents' argument is baseless. Whatever the merits of their claim that because fresh start financial statements are those of a new entity the auditor need not apply AU § 420 in auditing them, that argument fails here as a factual matter. Epicus did not adopt—and could not, consistent with SOP 90-7, have adopted—fresh start accounting until after Respondents issued their FY 2005 audit report. Therefore, Epicus was not a "new entity," as SOP 90-7 uses that term, at any point in FY 2005. Epicus was the same entity as it was in FY 2004. Accordingly, nothing in AU § 560 excused Respondents from their obligation to comply with AU § 420.

## **6. FY 2005 Accounts Receivable**

### Facts

In its FY 2005 financial statements, Epicus reported year-end accounts receivable of \$1,415,849, net of a \$500,000 allowance for doubtful accounts. The financial statements include a disclosure stating that, after it filed for bankruptcy under Chapter 11, Epicus:

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<sup>11/</sup> On May 5, 2010, the Division moved to adduce additional evidence consisting of the Form 10-KSB filed by Epicus for the fiscal year ended May 31, 2006. In its motion, the Division notes that the evidence was not relevant to the hearing because Respondents did not claim that their audit of Epicus's FY 2005 financial statements was affected by Epicus's adoption of fresh start accounting. Respondents make that claim for the first time on appeal. The Form 10-KSB offered by the Division provides evidence of what Respondents concede in their brief; specifically, it shows that Epicus did not adopt fresh start accounting until after it filed its FY 2005 financial statements. Accordingly, we grant the Division's motion.

adopted the policy of recording a net accounts receivable balance equal to the actual cash collected during the 30 day period subsequent to any reporting period. Any differential between the Company's actual accounts receivable and the actual subsequent cash collections is recorded as bad debt expense in the reporting period.

In effect, therefore, Epicus determined that it would retroactively write off, as uncollectible, any receivable amounts not collected within 30 days after year-end. In conducting their audit, Respondents accepted this approach; Hatfield testified that "this was one of the most conservative presentations that [Epicus] could develop." According to Respondents' work papers: "The actual AR balance is much higher [than the amount collected during the 30 day period]; however, the client has no monitoring or collection protocol in place to allow any collectability reliability on delinquent AR accounts."

Respondents' work papers indicate that Epicus's actual year-end accounts receivable totaled approximately \$2.6 million. Respondents determined that Epicus received \$1,384,849 in cash during the 30 day period following the end of FY 2005. As in FY 2004, Respondents did not attempt to determine whether any of that cash related to any specific receivable, and thus could not verify that the cash related to FY 2005 revenue. And once again, Respondents did not send confirmation requests to establish the existence of any receivable.

In testing the amount of receivables that should be reflected in Epicus's financial statements under its declared policy, Respondents, for reasons that are not clear, "grossed up" the actual cash collections by \$500,000, but offset that amount with a \$500,000 allowance for doubtful accounts, and they also added \$31,000, which Respondents determined was the average amount of carrier access fees collected by Epicus during the three month period prior to year-end FY 2005. This calculation supported the receivables (\$1,415,849, net of a \$500,000 allowance for doubtful accounts) reflected in Epicus's financial statements. Respondents also determined that Epicus should increase its bad debt expense for FY 2005 by \$711,664, in accordance with its stated policy to record the difference between the actual accounts receivable and the cash collected during the 30 day period as bad debt, and Epicus's financial statements reflect that the company accepted Respondents' proposed adjustment.

### Analysis

Under PCAOB interim auditing standards, Respondents were required to obtain sufficient competent evidential matter to afford a reasonable basis for their opinion and to exercise professional skepticism, including "a questioning mind and a critical assessment of the audit evidence," in their audit.<sup>12/</sup> With regard to Epicus's 2005

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<sup>12/</sup> AU §§ 230.07, 326.01.

accounts receivable, Respondents did nothing to test whether management's assumption that it would not collect receivables after 30 days was reasonable. This was so even though it was contrary to the representation Respondents had accepted, without testing, for their FY 2004 audit that Epicus received payment of a substantial portion of its receivables more than 30 days after year end. They also did nothing to trace any of the cash Epicus did receive during that 30 day period to any specific receivables, or to confirm the existence of any receivable.

Respondents contend that Epicus's methodology was reasonable under the circumstances of the bankruptcy proceeding and "the lack of personnel to monitor and pursue collection." Respondents argue that "[t]here was no evidence reviewed by the auditor to reasonably predict that there would be any collectability reliability beyond 30 days" and that tracing cash to receivables was unnecessary because "management recognized and accounted for potential bad debts at the point of billing, by recognition of bad debt of all the account receivable balance less the known cash collections in the following month." According to Respondents, "[t]he audit test to determine whether cash received in the 30 days following year end provided a reasonably accurate estimate of the year end accounts receivable balance is taken into account by the entries of 'debit-bad debt expense' and 'credits to accounts receivable.'"

The fact that Respondents did not review any evidence suggesting that management was incorrect when it assumed that it would not collect receivable amounts after 30 days is not a substitute for evidence that the assumption was reasonable, particularly in the face of management's representations to the contrary the previous year. Respondents also do not explain how Epicus's accounting for bad debt, as described in Respondents' briefs, provided them with evidence of the receivables' existence. Because Respondents did not perform sufficient procedures to test management's representations with regard to the accounts receivable and instead merely accepted management's representations, they failed to comply with PCAOB auditing standards.

## **B. The Bidville Audit**

Bidville, a Nevada corporation based in Florida, was established through a reverse merger with a publicly traded company in December 2003. Bidville's stock was quoted on the OTC Bulletin Board, and, at all relevant times, Bidville was an issuer, as defined in the Act and the PCAOB's rules. Bidville's expressed business plan was to operate an internet online auction site as a competitor to eBay.

Respondents became Bidville's auditor in connection with its FY 2003 audit, and issued an unqualified audit opinion on Bidville's 2003 financial statements.<sup>13/</sup> The financial statements, together with Respondents' opinion, were filed with the SEC in Bidville's annual Form 10-KSB for FY 2003.

Respondent Hatfield testified in his investigative testimony that at the time Respondents became Bidville's auditor, his assessment was that Bidville was "an eBay wannabe" and had been created as a "great stock spoof," a "stock game . . . a market play." He believed it was a "stock scam" and that the company's management "had no intent to run [a] company."<sup>14/</sup>

## **1. Private Placement Agreement**

### Facts

In December 2003, Bidville concluded a private placement through which it sold 4,410,000 shares of Bidville stock at \$.50 per share, "each Share with a ½ warrant. Each full such warrant convertible into one share of Bidville common stock at \$1.00 per share . . . ." The private placement stock was unregistered and restricted, and the warrants were also unregistered.

Respondents had no knowledge that this was other than an arm's length transaction. Respondents were not aware of the purchasers providing any services to Bidville in connection with the transaction or of any relationship between the purchasers and Bidville—they did not consider the issue relevant. Nevertheless, during their audit, Respondents proposed an adjustment to Bidville's financial statements in an amount equal to the difference between the "fair value" of the stock issued in the private placement and the actual proceeds of the private placement as "compensation expense related to common stock issuance at less than 'fair value,'" and Bidville made the adjustment.

Respondents calculated the fair value of the unregistered, restricted stock sold in the private placement by applying a 50% "haircut" to the reported closing price for Bidville's registered, freely tradable stock on the day the private placement closed.

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<sup>13/</sup> In connection with the reverse merger, Bidville changed its fiscal year-end from February 28 to December 31. As a result, the period covered by Respondents' audit was March 1, 2003 through December 31, 2003.

<sup>14/</sup> In his testimony during the investigation, Hatfield contended that subsequent events had substantiated his fraud concerns, but at the hearing he insisted that he had "no evidence that it actually came to pass." The issues in this case concern whether Respondents complied with PCAOB audit standards, not whether there was actually any fraudulent intent or action on the part of Bidville's management.

Based on this fair value, Respondents concluded that Bidville had realized approximately \$10 million less for the stock sold in the private placement than its fair value. In arriving at that amount, Respondents did not ascribe any value to the warrants that were included in the private placement. The adjustment that Respondents recommended and Bidville accepted accounted for \$10,051,800 of the \$10,296,897 in comprehensive loss reported by Bidville in its financial statements.

Respondents were not aware of any GAAP that required or supported either the need for a compensation expense adjustment or the 50% discount that they used in calculating fair value for purposes of the adjustment. Instead of relying on GAAP, Hatfield testified that, based on auditing similar transactions over a number of years, he relied on his understanding of industry practice and SEC staff approval to support both the need for an adjustment and the use of a 50% discount from market price to establish fair value.

More specifically, Hatfield testified: "The initial guidance came from a client who had significant securities experience, and then the position was later supported by the SEC through not issuing any comments on point during reviews of registration statements coming forward." In response to a question from his counsel, he confirmed that it was "the absence of any negative comment [from the SEC] on the treatment on the financial statements" he audited, rather than affirmative approvals from SEC staff, that he relied on. He based the Bidville adjustment on this experience; he did not consult the SEC staff about the Bidville transaction, specifically. Hatfield explained his understanding of the reason for calculating the fair value of the private placement stock based on a 50% discount from the market price for Bidville stock:

The theory behind [the 50% discount] originally was that in issuing restricted shares that had to be held for a defined period of time . . . there was always room for the market to shift and adjust to the detriment of the holder before they would be able to sell those shares in the open market. The unwritten industry accepted position from the very first time I became involved with this on a 1999 audit engagement was that the acceptable discount was 50 percent.

Respondents' expert, on the other hand, offered a different explanation, suggesting that the 50% "haircut" applied by Respondents in establishing the fair value of the private placement reflected a "blockage discount."

### Analysis

PCAOB interim auditing standards required Respondents to exercise due professional care and professional skepticism in their audit, and to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements. In particular, among other things, in order to exercise due care: "The auditor with final responsibility for the engagement should know, at a minimum, the

relevant professional accounting and auditing standards . . . ."<sup>15/</sup> Yet Respondents proposed a \$10 million adjustment, which the company accepted, without being aware of any GAAP that supported either the need for the adjustment or the manner in which they calculated it.

Respondents contend that Section 7520.2 of the SEC's Division of Corporation Finance's Financial Reporting Manual provides support for their approach to the adjustment, and that "[a]t the time the Bidville transaction occurred, the 50% adjustment to closing market price was then the industry (albeit unwritten) position, which was not unreasonable or inappropriate to the SEC staff or even to the FASB." Respondents also argue that the concurring reviewer "corroborated similar interaction with the SEC on accounting for the issuance of cheap stock" and that "Respondents also testified to prior experiences with the SEC on this issue."

Nothing in the cited provisions of the SEC staff manual suggests that issuers should apply a standard discount of 50% to shares sold under the circumstances of this case. Similarly, nothing in the testimony to which Respondents refer supports such an approach. Respondents do not suggest that the SEC staff considered the treatment of the Bidville shares and approved of it, but only that the SEC staff had not commented on similar accounting by other issuers. The lack of SEC staff comment on another company's accounting does not suggest, however, that the SEC approved of that other company's accounting, let alone that it was appropriate for Bidville.

Respondents had no reasonable basis for believing that their proposed adjustment to the Bidville financial statements was necessary or appropriate under GAAP, and thus had no reasonable basis for expressing an opinion that the financial statements, which included that adjustment, were fairly stated, in all material respects, in conformity with GAAP. Moreover, even assuming that a compensation expense adjustment was appropriate, and that for purposes of the adjustment it was necessary to determine the fair value of the private placement, Respondents failed to comply with PCAOB auditing standards in making that determination. Those standards required Respondents to obtain sufficient, competent evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP.<sup>16/</sup> Instead, Respondents used a 50% discount from the closing market price for Bidville's registered, freely tradable stock as the fair value for the stock in the private placement without obtaining any evidence that this provided a reasonable measure of the actual fair value of the private placement and without being aware of any GAAP supporting that valuation.

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<sup>15/</sup> AU § 230.06.

<sup>16/</sup> AU § 328.03.

## **2. Consulting Agreement**

### Facts

In December 2003, Bidville and the Royal Palm Capital Group, Inc. ("Royal Palm"), a company controlled by the same individuals who controlled Bidville, entered into a consulting agreement with National Securities Corporation ("National Securities"), which had conducted the private placement on behalf of Bidville. The agreement provided that National Securities was to provide financial, investment banking, and merger/acquisition services to Bidville, in exchange for which Royal Palm would transfer to National Securities, "upon execution of this Agreement," approximately four million shares of Bidville stock owned by Royal Palm, for a purchase price of \$500.

Respondents were unaware of the consulting agreement when they completed their audit of Bidville's 2003 financial statements and issued their opinion, and the OIP does not allege that they should have been aware of it at that time. Respondents requested copies of all consulting agreements involving Bidville during their audit, and were provided with several such agreements, but Hatfield testified that the one between Bidville, Royal Palm, and National Securities "was withheld from me." Respondents first learned of that consulting agreement on April 22, 2004.

On April 22, after the agreement came to light, Bidville management notified Respondents that it intended to file an amended Form 10-KSB, and that the amendments would "impact the financial statement disclosures." On April 29, 2004, after Bidville management provided an initial draft of the amended form to Respondents for their review, Hatfield advised Bidville's president that he believed Bidville had "no one that knows how to characterize and disclose the myriad of deals and contracts being entered into." On May 3, 2004, Hatfield notified Bidville's president that, because of "this behavior pattern and lack of internal control," Respondents were evaluating whether they would continue to serve as Bidville's auditor.

On May 7, 2004, Bidville filed its amended Form 10-KSB with the SEC that disclosed the consulting agreement, but made no adjustments to Bidville's previously filed financial statements. The amended form included an unqualified opinion from Respondents that Bidville's previously filed financial statements were fairly presented in conformity with GAAP, in all material respects, and that the consulting agreement "had no effect on the Company's financial statements."

Hatfield reached that conclusion because he concurred in "an interpretation of management . . . that the contract was not triggered until consideration was provided on both sides of the contract." Hatfield received a Bidville shareholder list that did not include National Securities, but he did not contact National Securities or take any other steps to determine whether management's interpretation of the contract was correct.

Respondents later concluded that management's interpretation was incorrect, and that Bidville should have recorded the impact of the agreement on its FY 2003 financial statements. In October 2004, Bidville filed another amended Form 10-KSB that included a restatement of its FY 2003 financial statements in which it recognized a charge of approximately \$15.8 million attributable to the consulting agreement. The filing included Respondents' unqualified opinion that the restated financials were fairly presented, in all material respects, in conformity with GAAP.

On May 21, 2004, Respondents issued a review report in connection with Bidville's planned filing of a Form 10-QSB for the quarter ending March 31, 2004. In the review report, Respondents stated that they were "not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles." By May 24, however, prior to the filing of the Form 10-QSB, Respondents learned that the Royal Palm shares had been transferred to National Securities in February 2004, and Hatfield sent an email to the president of Bidville indicating his belief that the financial statements included in the Form 10-QSB should reflect "3,966,700 shares @ \$3.00'ish, discounted by 50% less the \$500 as a charge to the P&L for consulting fees and a credit to additional paid-in capital." Hatfield noted in the email, however, that "[t]o make this change would totally blow the timeline to file today," and that Bidville's chairman and CEO had "agreed to let the filing go and we'll book the effect of this off-balance sheet transaction in the next quarter." Respondents did not withdraw or modify their review report, and the Form 10-QSB was filed on May 25, 2004.

Although his email indicated that Bidville planned to book the transaction "in the next quarter," Hatfield testified that, in fact, Bidville's management had represented that it would file an amended Form 10-QSB with corrected financial statements within five days, and that Respondents agreed to the filing of the Form 10-QSB based on that representation. Bidville did not, however, file an amended form within five days. In June, Hatfield sent an email to Bidville's president indicating that "the 3/31/04 10-QSB should be amended as [the National Securities] transaction took place in 2/04 and was not recorded in the Bidville financial statements." In early July, he received a reply indicating that Bidville was "actively working" on an amended form.

By letter dated August 2, 2004, Respondents withdrew as Bidville's auditor, citing the circumstances surrounding the National Securities consulting agreement. In the letter, Respondents indicated their belief that the failure to account for the consulting agreement transaction in the company's financial statements, as filed in the Form 10-QSB, caused the statements "to not be 'materially correct' and not presented in accordance with generally accepted accounting principles."

After Respondents resigned, they were approached by Bidville and asked to assist with a restatement of the company's FY 2003 financial statements, and they accepted the assignment. As noted above, Bidville filed an amended Form 10-KSB with

the SEC on October 1, 2004, which contained the restated financial statements, as well as Respondents' unqualified opinion.

### Analysis

AU § 561.01 of the Board's interim auditing standards required that "the auditor who, subsequent to the date of the report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected the report had he or she then been aware of such facts" perform certain procedures to determine whether those facts would have affected the audit report. The procedures required depended on the particular facts and circumstances, but if the new information "is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report."<sup>17/</sup> If the auditor determines that the information is reliable, and the facts existed at the time of the report, the auditor may be required to advise the client to disclose the facts through the issuance of revised financial statements, together with a new audit report disclosing the reasons for the revisions, and if the client fails to make such disclosures, the auditor is required to take additional steps.<sup>18/</sup>

Respondents argue that they took appropriate steps upon learning of the consulting agreement. Specifically, they appear to contend that they did more than simply accept management's interpretation of the contract in determining that the contract had not yet been "triggered" because consideration had not been provided "on both sides of the contract." They claim that:

The independent third party transfer agent report did not show the shares issued and/or transferred on the shareholder list. Audit programs direct an auditor to confirm stock issuances with the third party transfer agent. Respondents did this. Respondents also inquired of management and received a response consistent with the transfer agent record. (internal citation omitted.)

We can find no evidence in the record, however that Respondents, confirmed stock issuances with the third party transfer agent. Rather, Hatfield testified, he received a shareholder list from Bidville management, which did not show an issuance of stock to National Securities. Nor can we identify evidence that Respondents did anything else to evaluate whether the consulting agreement had a material effect on Bidville's financial statements, other than talking to Bidville management. Although Hatfield had expressed his belief that Bidville had no one who knew how to characterize and disclose a consulting agreement, and that Bidville's management was planning, or

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<sup>17/</sup> AU § 561.04.

<sup>18/</sup> AU §§ 561.05-561.09.

engaged in, a "stock spoof" or a "stock scam," Respondents failed to undertake any reasonable investigation to determine whether the agreement had a material effect on Bidville's financial statements. Instead, they accepted Bidville management's interpretation of the agreement without testing it. As a result, Respondents lacked a reasonable basis for expressing the opinion, included in the amended Form 10-KSB filed on May 7, 2004, that the agreement had no effect on Bidville's financial statements.

Respondents also failed to comply with PCAOB interim auditing standards requiring them to exercise due care and professional skepticism in connection with their review of the Form 10-QSB that Bidville filed on May 25, 2004. On May 21, Respondents issued a review report indicating that they were unaware of any material modifications required to make the financial statements conform to GAAP. But before Bidville filed the Form 10-QSB, Respondents had determined, and advised Bidville, that the consulting agreement required an adjustment to Bidville's financial statements for the quarter of approximately \$6 million.

In their resignation letter, Respondents stated that Bidville's failure to make this adjustment had caused its financial statements to be materially misstated, yet they nevertheless allowed Bidville's management to file the Form 10-QSB, without objection. During his investigative testimony, Hatfield stated that in allowing the filing without objection, he "rolled over." Worse yet, he did so even though, he testified, he believed that Bidville management "want[ed] to get filings into the marketplace as quick as possible so that they can do smoke-and-mirror fluffing press releases to pump the stock . . . . This company is a premier example of an entity that could be subject to a pump and dump."

At the hearing, Hatfield testified that in allowing Bidville's management to file the Form 10-QSB without objection he relied on management's representation that the company would file an amended form, correcting the financial statements, within five days. The hearing officer found that this testimony lacked credibility. On appeal, Respondents argue that Gary Alexander, who was employed by Bidville, also testified that management represented that it would file a revised Form 10-QSB within five days. According to Respondents, after they "tested all the information provided by management, Respondents determined, as was acceptable practice at the time, [Bidville] would restate and quantify the material impact of this undisclosed transaction by the quarter filing following the discovery of the undisclosed transaction."

It is unnecessary to determine whether, in fact, Bidville management represented that it would amend its filing. The relevant fact is that Respondents knowingly allowed Bidville to include in its filing a review report that falsely claimed that Respondents were unaware of any material modifications required to make the financial statements conform to GAAP. Permitting a client to include in its filing a review report that makes false claims was not "acceptable practice" at the time of the Bidville audit, nor is it now. Indeed, Respondent's own expert testified that if an auditor thought the

client was engaged in a fraud, "you either insist that [the client] issue a Form 8-K or you communicate with the Commission or you withdraw," and he conceded that Respondents "did not do any of those things." While the expert nevertheless expressed the opinion that Respondents actions were reasonable, the facts do not support that view.

### **C. Summary of Violations**

For the reasons set forth above, we conclude that, in connection with their FY 2004 audit of Epicus, Respondents violated PCAOB Rules 3100 and 3200T by:

- failing to perform procedures to evaluate whether Epicus's departure from GAAP in recognizing revenue caused Epicus's financial statements to be materially misstated, which failure violated PCAOB auditing standards, including AU §§ 150 and 230;
- failing to request confirmation of Epicus's accounts receivable, without having an adequate basis for making a determination that sending requests for confirmation of accounts receivable would be ineffective, which violated PCAOB auditing standards, including AU §§ 150, 230, 326 and 330;
- failing to perform adequate alternative procedures to test the existence of accounts receivable, which violated PCAOB auditing standards, including AU §§ 150, 230, 326 and 330; and
- failing to perform sufficient audit procedures to evaluate the collectability of accounts receivable and to conclude that Epicus's allowance for doubtful accounts was reasonable, which violated PCAOB auditing standards, including AU §§ 150, 230 and 326.

Further, in connection with their FY 2005 audit of Epicus, Respondents violated PCAOB Rules 3100 and 3200T by:

- failing to consider adequately the implications of a change in revenue recognition by Epicus, failing to address adequately Epicus's failure to disclose the change in its financial statements, and failing to consider whether accounting principles were consistently applied between periods, which violated PCAOB auditing standards, including AU §§ 150, 230, and 420; and
- failing to perform sufficient procedures to evaluate the reasonableness of Epicus's estimate of the 2005 year-end accounts receivable balance, which violated PCAOB auditing standards, including AU §§ 150, 230 and 326.

Finally, in connection with their FY 2003 audit of Bidville, Respondents violated PCAOB Rules 3100 and 3200T by:

- failing to perform sufficient procedures to determine whether Bidville had correctly valued and presented the results of a private placement in its financial statements, which violated PCAOB auditing standards, including AU §§ 150, 230 and 326; and
- failing to properly respond after they became aware, in April 2004, of a December 2003 consulting agreement that had not been disclosed or accounted for in Bidville's 2003 financial statements, which violated PCAOB auditing standards, including AU §§ 150, 230, 326 and 561.

### III.

Section 105(c)(4) of the Act gives the Board authority to impose sanctions on registered firms or associated persons for violations of PCAOB rules and audit standards. In appropriate circumstances, sanctions may include revoking a firm's registration, barring an associated person, or imposing a civil money penalty. Section 105(c)(5), however, provides that the Board may impose a revocation or bar only for "intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or . . . repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard."<sup>19/</sup> PCAOB Rule 5300 provides that "the Board may impose such disciplinary or remedial sanctions as it determines appropriate, subject to the applicable limitations under Section 105(c)(5) of the Act . . . ." In determining the appropriate sanctions in this case, therefore, the first question that must be addressed is whether Respondents' violations rise to the level of conduct specified in Section 105(c)(5).

Respondents argue that their conduct cannot be reckless, because, at most, Respondents' conduct merely represented "a departure from ordinary care." Respondents contend that "[t]he issues here all concern auditor judgment and/or sufficiency of work papers, not audit failure," that "[t]he Hearing Officer's findings, disagreeing with a seasoned auditor's judgment, is a case of 20/20 hindsight," that "[a] difference in opinion regarding an auditor's judgment turns on what appears to have been reasonable at the time," and that "[r]easonableness is the underpinning of the concept of negligence, not the concept of recklessness."

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<sup>19/</sup> Section 105(c)(4) provides that civil money penalties for conduct that does not meet the standards set forth in Section 105(c)(5) of the Act are limited to \$100,000 against an individual and \$2 million against a registered firm.

Respondents correctly note that in this context recklessness is defined as an extreme departure from the standards of ordinary care that presents a danger to investors or the markets that is either known to the actor or is so obvious that the actor must have been aware of it.<sup>20/</sup> Respondents' conduct easily satisfies this standard. The record is replete with examples of Respondents' extreme departures from the standard of ordinary care.

Hatfield was an experienced auditor who specialized in auditing "microcap" and "nanocap" companies like Epicus and Bidville. In auditing Epicus in 2004, Respondents knew that the company's revenue recognition practice was not in conformity with GAAP. Respondents also knew that Epicus had, nevertheless, employed the same practice in preparing its FY 2004 financial statements. They further knew that in order to express an opinion that Epicus's financial statements were fairly presented, they were required to evaluate whether the GAAP departure caused a material misstatement under GAAP. In spite of this, Respondents issued an unqualified opinion without having conducted any meaningful materiality assessment.

In the same audit, Respondents declined to send confirmation requests without any reasonable basis for their failure to do so. In attempting to perform alternative procedures to confirm the existence of Epicus's accounts receivable, Respondents failed to match cash receipts to specific receivables and relied on untested representations from Epicus' management. These facts reflect much more than a mere disagreement about "judgment" or documentation. They demonstrate that Respondents' conduct in connection with the 2004 Epicus audit was at least reckless.

Respondents' conduct during the Bidville audit was even more troubling. Hatfield admitted that he believed, at the time they accepted the Bidville engagement, that the company was a "scam," and that Bidville management "want[ed] to get filings into the marketplace as quick as possible so that they can do smoke-and-mirror fluffing press releases to pump the stock." Yet, Respondents acquiesced in the company's filing of a review report that Respondents knew was false and misleading. Respondents claim

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<sup>20/</sup> See Gately & Assoc., Exchange Act Rel. No. 62656 (Aug. 5, 2010). Respondents argue that there is no evidence to support the conclusion that, assuming Respondents were reckless, there was "a danger of misleading anyone who reviewed and relied upon Respondents [sic] opinions." But contrary to Respondents' claim that this case does not involve audit failure, the facts, as described above, show that Respondents issued audit reports without performing sufficient procedures or gathering sufficient evidence to support the unqualified opinions they expressed. Respondents also allowed a client to file a review report that they knew contained a false statement. Such conduct presents a grave risk to investors. Respondents also argue that there was no evidence that the financial statements they audited were materially incorrect, but that is irrelevant to our determination of whether Respondents conduct was at least reckless.

that their acquiescence was based on the company's agreement that it would amend its filing within five days. But even assuming that to be the case, Respondents' contention that they originally meant to go along with the misleading of investors for only five days is not helpful to them on the question of whether their conduct rises to the level of recklessness. Their own assertions make plain that their conduct in this regard was intentional and knowing, as was their conduct, even after the initial five-day period, in continuing to allow investors to be misled for more than two months before withdrawing.

Having determined that we may, consistent with the Act and the Board's rules, impose a revocation and bar does not alone answer the question of what sanctions are appropriate for the violations in this case. We separately address that issue here.

Respondents argue that the penalties imposed by the hearing officer in this case are more severe than sanctions imposed in cases that, they claim, included more egregious conduct. According to Respondents, this case is different from the Board's other cases because this matter involves "sufficiency of the work papers, or the auditors [sic] judgment in utilizing alternative procedures to verify and test various components of the audit." Accordingly, Respondents claim that the sanctions imposed by the hearing officer are excessive, unmerited, and punitive.

In determining an appropriate sanction, our goal is to protect the investing public. For reasons already described, we do not credit Respondents' argument that this case is about the sufficiency of Respondents' workpapers or their exercise of judgment. We have found that, among other things, Respondents "rolled over"—as they described it—in allowing a company that they believed was a "scam" to file a review report that they knew was misleading. This conduct is a violation of so fundamental an obligation that it alone demonstrates Respondents' unfitness to audit public companies. But it is not the only conduct at issue, and numerous other violations resulted from conduct of Respondents that was at least reckless.<sup>21/</sup> If Respondents are allowed to continue to audit public companies, they will have opportunities for similar violations in the future.

Not only does Respondents' argument about the severity of the sanctions rest on a characterization of their conduct that is at odds with our findings, it also overstates the potential relevance of comparisons to the other cases they cite, all of which were settled. As the SEC has noted, "the appropriate sanction depends on the facts and circumstances of each particular case and cannot be determined precisely by comparison with actions taken in other proceedings."<sup>22/</sup> Under the facts and

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<sup>21/</sup> We also find that Respondents engaged in repeated instances of conduct that was at least negligent, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

<sup>22/</sup> See, e.g., Ronald Pellegrino, Exchange Act Rel. No. 59125, 2008 SEC Lexis 2843, at \*68 (Dec. 19, 2008). The SEC has also noted that:

circumstances of this case, revoking the Firm's registration with the Board and barring Hatfield from association with any registered firm is not excessive, unmerited, or punitive. On the contrary, the record amply demonstrates that allowing Respondents to continue to engage in audits of issuers would pose too great a risk to investors. It is therefore in the public interest to permanently revoke the Firm's registration and to permanently bar Hatfield from associating with any registered accounting firm.<sup>23/</sup>

An appropriate order will issue.<sup>24/</sup>

By the Board.<sup>25/</sup>

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parties that settle disciplinary proceedings often receive less severe sanctions than those who do not. . . . [T]he sanctions that are imposed in settled cases are the result of a myriad [of] "pragmatic considerations such as the avoidance of time- and manpower-consuming adversarial litigation" that enter into decisions to accept offers of settlement from respondents. For this reason, they cannot be meaningfully compared to the sanctions imposed in litigated cases, which are the result of fact-specific considerations of various factors designed to protect the public interest.

Joseph John Vancook, Exchange Act Rel. No. 34-61039A, 2009 SEC LEXIS 3872, at \*79-80 (Nov. 20, 2009) (footnotes omitted).

<sup>23/</sup> We decline to impose a civil money penalty on Respondents, because we are not convinced that that additional sanction, in this instance, is necessary to protect investors.

<sup>24/</sup> 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.

<sup>25/</sup> Certain members of the Board participated in this decision without having been present for the oral argument before the Board on July 27, 2010. Pursuant to PCAOB Rule 5463(d), each such Board member reviewed the transcript of the oral argument prior to such participation.

