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Public Company Accounting Oversight Board

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ORDER MAKING FINDINGS AND IMPOSING SANCTIONS *In the Matter of Randall A. Stone, CPA,* *Respondent.*	PCAOB Release No. 105-2014-007 July 7, 2014

By this Order, the Public Company Accounting Oversight Board ("Board" or "PCAOB") is (1) censuring Randall A. Stone, CPA ("Stone"); (2) imposing a civil money penalty in the amount of $50,000; and (3) barring Stone from being associated with a registered public accounting firm.[1] The Board is imposing these sanctions on the basis of its findings concerning Stone's violations of PCAOB rules and auditing standards in connection with (1) the audit of the consolidated financial statements of ArthroCare Corporation ("ArthroCare" or "Company") for the fiscal year ended December 31, 2007, and (2) the consent to incorporate by reference the fiscal year 2007 audit report in a Form S-8 Registration Statement filed by ArthroCare with the United States Securities and Exchange Commission ("Commission" or "SEC") in June 2008.

I.

On December 19, 2012, the Board instituted disciplinary proceedings against Stone pursuant to Section 105 of the Sarbanes-Oxley Act of 2002, as amended ("Act"), and PCAOB Rule 5200(a)(1). These proceedings were not public pursuant to Section 105(c)(2) of the Act and PCAOB Rule 5203. The Board determined, under Section 105(c)(2) and PCAOB Rule 5203, that good cause was shown to make the hearing in this proceeding public, and the Division of Enforcement and Investigations consented to making the hearing public. As permitted by Section 105(c)(2) and PCAOB Rule 5203, Stone did not consent to make the hearing in this proceeding public.

II.

In response to these proceedings, and pursuant to PCAOB Rule 5205, Stone has submitted an Offer of Settlement ("Offer") that the Board has determined to accept. Solely for purposes of this proceeding and any other proceedings brought by or on

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[1] Stone may file a petition for Board consent to associate with a registered public accounting firm after three (3) years from the date of this Order.

behalf of the Board, or to which the Board is a party, and without admitting or denying the findings herein, except to the Board's jurisdiction over him, which is admitted, Stone consents to entry of this Order Making Findings and Imposing Sanctions ("Order") as set forth below.[2]

III.

On the basis of Stone's Offer, the Board finds that:[3]

A. Respondent

1. Randall A. Stone, age 51, of Austin, Texas, is a certified public accountant licensed under the laws of Texas (license no. 047916). At all relevant times, Stone was a partner in the Austin, Texas office of PricewaterhouseCoopers LLP ("PwC"), a registered public accounting firm, and was an associated person of a registered public accounting firm as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i). Stone retired from PwC effective June 30, 2014.

B. Summary

2. This matter concerns Stone's failures to comply with PCAOB rules and standards in auditing revenue recognized by ArthroCare and reported in its 2007 financial statements. As the PwC partner in charge of the 2007 ArthroCare audit, Stone ignored or failed to properly evaluate numerous indicators—known to him during the audit—that should have alerted him to the possibility that ArthroCare may have been engaging in fraudulent financial reporting by improperly recognizing revenue on sales to DiscoCare, Inc. ("DiscoCare"), one of its largest distributors. By the time he authorized issuance of PwC's 2007 audit report, Stone was aware of considerable information that individually and collectively should have called into question whether ArthroCare's

[2] The findings herein are made pursuant to Stone's Offer and are not binding on any other persons or entities in this or any other proceeding.

[3] The Board finds that Stone's conduct described in this Order meets the conditions set out in Section 105(c)(5)(A) of the Act, 15 U.S.C. § 7215(c)(5), which provides that certain sanctions may be imposed in the event of (1) intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable statutory, regulatory, or professional standard; or (2) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

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revenue from DiscoCare sales was realized or realizable, and earned, in accordance with U.S. generally accepted accounting principles ("GAAP"), including whether collectibility was reasonably assured. For example, despite appropriately identifying specific fraud risks relating to revenue recognition, Stone ignored repeated indications that DiscoCare may have relied on service fee payments received from ArthroCare to fund its purchases. Nevertheless, he failed to properly test or otherwise assess whether ArthroCare's revenue recognition complied with GAAP. Stone also failed to properly evaluate, using all of the information at his disposal, the business rationale for ArthroCare's significant and unusual sales transactions with DiscoCare. He repeatedly accepted management representations without applying the necessary auditing procedures, evaluating contradictory audit evidence, obtaining sufficient competent audit evidence, and exercising the requisite due care and professional skepticism.

3. This matter also concerns Stone's failure to comply with PCAOB rules and standards in auditing ArthroCare's accounting for its acquisition of DiscoCare on December 31, 2007. Stone failed to exercise due professional care and skepticism by agreeing with the Company's proposed accounting for the acquisition without adequately assessing whether such accounting treatment complied with GAAP. Stone also failed to properly audit management's assertions regarding the existence or occurrence, rights and obligations, and the fair market valuation of the accounts receivable acquired from DiscoCare.

4. Finally, this matter involves Stone's improper authorization of PwC's consent to include the 2007 audit report in ArthroCare's Form S-8 Registration Statement filed with the SEC on June 6, 2008, which registered shares for the Company's employee incentive stock plan. On May 30, 2008, PwC's Office of General Counsel received two anonymous faxes that included allegations of material errors in ArthroCare's current and past financial statements, and forwarded the faxes to Stone. Although many of the allegations were similar to those Stone had learned about during the 2007 audit, the faxes also contained new and more detailed allegations. Stone knew that ArthroCare was assessing these most recent allegations and was in the process of preparing a detailed written response to the allegations for PwC. Before he received ArthroCare's written response or completed a reasonable subsequent facts investigation, Stone improperly authorized PwC's consent to incorporate by reference the 2007 audit report in ArthroCare's Form S-8 filing.

C. <u>Background</u>

5. Stone was the engagement partner on PwC's audits of the consolidated financial statements of ArthroCare for the fiscal years ended December 31, 2005 through 2009. At all relevant times, ArthroCare was a medical device company that developed, manufactured and marketed disposable devices for minimally invasive

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surgeries, including a device called the SpineWand. At all relevant times, ArthroCare's common stock was registered under Section 12(b) of the Securities Exchange Act of 1934, and was quoted on the NASDAQ Stock Market. At all relevant times, ArthroCare was an issuer as that term is defined in Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii).

6. On February 29, 2008, Stone authorized PwC's issuance of a standard audit report expressing an unqualified opinion on ArthroCare's financial statements and internal control over financial reporting for the year ended December 31, 2007. A few months later, on June 6, 2008, he authorized PwC's consent to incorporate by reference that audit report in a Form S-8 Registration Statement filed by ArthroCare with the Commission.

7. On July 21, 2008, as a result of an internal reassessment, ArthroCare filed a Form 8-K with the SEC announcing that it would restate its financial statements for several periods, including the year ended December 31, 2007. The Company disclosed that "[t]he restatement follows a recommendation by management that revenue in these previously issued financial statements should be adjusted because: [among other things,] the relationship between the Company and DiscoCare, Inc. during the periods being restated was a sales agent relationship, rather than that of a traditional distributor…. The Company will therefore account for sales by ArthroCare of products to [DiscoCare] from the third quarter of 2006 to March 31, 2008, under a sell-through revenue recognition method …, as opposed to a sell-in method." The Company also disclosed that "[m]anagement's reassessment of its prior accounting for sales to distributors resulted from discussions initiated by PwC." ArthroCare's common stock closed at $23.21 per share that day, down 42 percent from its Friday, July 18, 2008 closing price of $40.03.

8. On November 18, 2009, following a detailed Audit Committee Review, ArthroCare filed a Form 10-K restating its financial statements for 2007 and other periods. The Review focused on two areas: (1) accounting issues and internal controls and (2) insurance billing and healthcare compliance issues. As disclosed in that Form 10-K: "The Review identified facts indicating that the Company's sales management and certain other senior managers maintained a significant focus on achieving particular revenue growth objectives over time." Further, "a substantial number of the transactions that were … corrected as a result of the restatement were quarter-end transactions and were frequently structured by the Company's sales management to result in revenue being recognized in a particular quarter in order to meet revenue forecasts." ArthroCare also disclosed that "[i]n a majority of the transactions reviewed, sales personnel involved in the transactions at issue, including a former executive officer, did not communicate information and practices bearing on revenue recognition and related matters to the Company's finance personnel, and as a consequence, it appears that the

information was not conveyed to the Company's independent registered public accounting firm."

9. The auditing matters at issue in this proceeding concern ArthroCare's transactions with DiscoCare, a privately-held Florida company that was ArthroCare's largest distributor in 2007.

The DiscoCare Agreement

10. Effective November 1, 2006, ArthroCare and DiscoCare entered into a five-year "Consulting, Services and Purchasing Agreement" ("2006 Agreement"), which superseded a 2005 purchasing agreement between the parties. The 2006 Agreement designated DiscoCare as ArthroCare's "exclusive consultant" in the U.S. for collection from third-party payors for surgical procedures using the SpineWand. The then-audit manager sent Stone an email about the new agreement on October 31, 2006, describing it as "a new type of revenue deal for [ArthroCare]."

11. Under the 2006 Agreement, DiscoCare was obligated to pay ArthroCare for SpineWands at varying prices and payment terms depending on case-type. Under the agreement's original terms, the price was $5,750 per unit for personal injury cases; $6,500 for workers compensation cases; $3,000 for private health insurance cases with a "carve out"; and $1,400 per unit for cases with no "carve out."[4] Payment terms were 360 days for personal injury cases and 180 days for all others. Stone understood that these prices were substantially higher than those charged to ArthroCare's other customers, and he knew, or should have known, that these extended payment terms were substantially longer than those offered to ArthroCare's other customers.

12. Stone also knew that the 2006 Agreement obligated ArthroCare to pay a monthly service fee to DiscoCare, purportedly for consulting services, the nature of which was not specified in the agreement. The service fee amounts were based on sales volume and average selling price. Payable within 20 days of each month-end (well in advance of DiscoCare's 180-360 day payment obligations), the service fee was calculated using a formula based on total monthly SpineWand sales to DiscoCare and the average price of SpineWands sold that month. During 2007, the service fee approximated 50 percent of the amounts invoiced to DiscoCare for SpineWands each month. Stone knew that half of the monthly service fee was being applied against the

[4] Although not clearly defined in the 2006 Agreement, "carve out" appears to relate to the process for how the products will be reimbursed.

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accounts receivable owed by DiscoCare and the other half was being paid to DiscoCare in cash. None of ArthroCare's other distributors had a similar arrangement.

13. Stone understood that under the 2006 Agreement's original terms, (1) ArthroCare would "drop-ship" SpineWands directly to customers (e.g., hospitals, surgical centers, and surgeons) for use in approved surgical procedures; (2) DiscoCare would be invoiced for the products, would be responsible for paying ArthroCare for those products per the terms of the Agreement, and would be assigned the right to collect payments from third-party payors (e.g., from private health insurance providers, workers compensation insurers, and personal injury recoveries) for the products; and (3) DiscoCare would not hold SpineWand inventory or resell SpineWands purchased from ArthroCare.

14. For the 2006 Agreement, ArthroCare management concluded that "revenue will be recorded when the product is shipped to the customer and monthly the service fee paid to DiscoCare will be recorded in operating expenses." Stone concurred in both aspects of the Company's accounting treatment. Management discussed the principal terms of, and the accounting for, the 2006 Agreement with the Audit Committee. A Company-prepared memorandum provided to PwC and the Audit Committee in December 2006 justified expensing the monthly service fee (as opposed to recording it as a reduction in revenue, which GAAP generally requires for consideration given to a customer) based on its conclusion that DiscoCare was not acting in the capacity of a reseller of ArthroCare's products, and therefore not a customer. PwC's work papers concluded that expensing the monthly service fee was appropriate because "an entity cannot be both an agent … and a reseller … in respect to the same transaction."

15. The 2006 Agreement was amended in March 2007 to allow DiscoCare to maintain SpineWand inventory, in lieu of ArthroCare drop-shipping directly to customers. Concurrently, ArthroCare and DiscoCare entered into a bill and hold arrangement by which SpineWands were segregated in a dedicated location in ArthroCare's warehouse facilities, and later shipped on to customers. Stone concurred with ArthroCare recognizing revenue when SpineWands were segregated in ArthroCare's facilities. And when the bill and hold arrangement ended in or about July 2007, Stone also concurred with ArthroCare recognizing revenue when ArthroCare shipped SpineWands to DiscoCare's new warehouse location in Florida.

16. Although DiscoCare was then holding inventory like a reseller, ArthroCare continued to record the service fees as operating expenses (and not as a reduction in revenue), based on the Company's reassessment and renewed conclusion DiscoCare was not acting in the capacity of a reseller. Stone concurred in this accounting treatment.

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Surge in DiscoCare-Related Revenue and Receivables in 2007

17. Following the 2006 Agreement, ArthroCare's sales to DiscoCare, and the related receivables, grew rapidly. Sales to DiscoCare represented almost 10 percent of ArthroCare's total reported revenue in 2007, up from 2 percent in 2006. As of December 31, 2007, the accounts receivable from DiscoCare had grown to $26.2 million, or 29 percent of ArthroCare's gross trade accounts receivable balance, compared to only 7 percent at December 31, 2006. Stone knew of these increases through, among other things, his periodic receipt of client-prepared schedules showing DiscoCare's monthly purchases and payments.

ArthroCare's 2007 Public Disclosures Regarding Its Revenue and Earnings Targets

18. Throughout 2007, ArthroCare's press releases routinely included revenue, earnings and other forecasts, and touted the Company's achievement of management and analyst expectations. It was the general practice of Stone and his engagement team to review press releases and other communications made by the Company to the investing public and analysts.

19. At the outset of 2007, for example, ArthroCare publicly disclosed its earnings and performance expectations for the full year. In a February 15, 2007 press release, the Company said it expected "total revenue growth of 20 percent" in 2007, noting that "[s]pine business unit revenue growth is anticipated to be at least 50 percent." The Company also disclosed that its GAAP diluted earnings per share ("EPS") for 2007 was expected to be in the range of $1.40 to $1.50. In addition, ArthroCare disclosed that it "expects further improvement in both product and operating margins and for earnings to continue to grow faster than revenue." Subsequent quarterly earnings releases in 2007 emphasized the Company's strong sales growth, in each instance highlighting increased sales in its spine business unit, which primarily resulted from the increased SpineWand sales to DiscoCare.

20. As disclosed in a press release dated February 19, 2008, ArthroCare met or exceeded the 2007 full-year results it forecast a year earlier. Specifically, full-year revenue increased 21 percent (20 percent was forecast); GAAP diluted EPS was $1.50 (the Company's original $1.40-$1.50 forecast was revised upward to $1.48-$1.50 in October 2007); and spine sales increased 68 percent (at least 50 percent was forecast). The Company also announced that its full-year product margin increased 3 points (from 70 to 73 percent) over 2006. ArthroCare further disclosed that its 2007 fourth quarter revenue grew 25 percent, "exceed[ing] consensus estimates," and its fourth quarter EPS was $0.50, which met its revised fourth quarter guidance of $0.48-$0.50.

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ArthroCare Acquired DiscoCare at the End of 2007

21. As of December 31, 2007—the last day of its fiscal year—ArthroCare acquired DiscoCare in a stock purchase transaction. As a result of the acquisition, the 2006 Agreement ended. Through the post-acquisition consolidation of DiscoCare, the acquisition also eliminated the $26.2 million receivable that DiscoCare owed ArthroCare for purchases through December 31, 2007, but not the 2007 revenue recognized by ArthroCare on its pre-acquisition sales to DiscoCare.

D. Stone Failed to Comply with PCAOB Standards in Connection with PwC's Fiscal Year 2007 Audit of ArthroCare

22. As the engagement partner on the 2007 audit, Stone led the PwC engagement team, had final responsibility for the audit within the meaning of AU § 311, *Planning and Supervision*, and authorized the issuance of PwC's unqualified audit opinion.[5] In connection with the preparation or issuance of an audit report, PCAOB rules require that associated persons of registered public accounting firms comply with the Board's auditing standards.[6] Under PCAOB auditing standards, an auditor may express an unqualified opinion on an issuer's financial statements only when the auditor has formed that opinion on the basis of an audit performed in accordance with PCAOB standards.[7] Among other things, those standards require that an auditor exercise due professional care, exercise professional skepticism, and obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements.[8]

23. Under PCAOB standards "[t]he auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a

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[5] This Order applies PCAOB auditing standards in effect at the time of the conduct described herein.

[6] PCAOB Rule 3100, *Compliance With Auditing and Related Professional Practice Standards*, and PCAOB Rule 3200T, *Interim Auditing Standards*.

[7] See AU § 508.07, *Reports on Audited Financial Statements*.

[8] See AU § 150, *Generally Accepted Auditing Standards*; AU § 230, *Due Professional Care in the Performance of Work*; AU § 326, *Evidential Matter*.

belief that management is honest."[9] Further, "[i]n developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements."[10] Although management representations "are part of the evidential matter the independent auditor obtains, … they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."[11] Moreover, if a management representation "is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified."[12]

24. In addressing consideration of fraud in an audit, PCAOB standards provide that "'[t]he auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.'"[13] Auditors should "thoroughly probe the issues, acquire additional evidence as necessary, and consult with other [audit] team members and, if appropriate, experts in the firm, rather than rationalize or dismiss information or other conditions that indicate a material misstatement due to fraud may have occurred."[14]

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9 AU § 230.09.

10 AU § 326.25.

11 AU § 333.02, *Management Representations*.

12 AU § 333.04.

13 AU § 316.01, *Consideration of Fraud in a Financial Statement Audit*, quoting AU § 110.02, *Responsibilities and Functions of the Independent Auditor*.

14 AU § 316.16; see also AU § 316.46 ("As noted in paragraph .13 [of AU § 316], professional skepticism is an attitude that includes a critical assessment of the competency and sufficiency of audit evidence. Examples of the application of professional skepticism in response to the risks of material misstatement due to fraud are (a) designing additional or different auditing procedures to obtain more reliable evidence in support of specified financial statement account balances, classes of transactions, and related assertions, and (b) obtaining additional corroboration of management's explanations or representations concerning material matters….").

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25. In the case of "significant transactions that are outside the normal course of business for the entity [under audit], or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment," the auditor "should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting …."[15] PCAOB standards further provide that "[i]n understanding the business rationale for the transactions, the auditor should consider [among other things] … [w]hether management has discussed the nature of and accounting for such transactions with the audit committee or board of directors," "[w]hether the transactions involve … parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit," and "[w]hether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction."[16]

26. In auditing fair value measurements made by management, "[t]he auditor should … evaluate whether the fair value measurements have been properly determined[, including] whether the data on which the fair value measurements are based … is accurate, complete and relevant…."[17] In the absence of observable market prices, PCAOB standards recognize that "GAAP requires fair value to be based on the best information available in the circumstances."[18] In addition, "[t]he auditor should evaluate the sufficiency and competence of the audit evidence obtained from auditing fair value measurements," as well as "evidence obtained from other audit procedures [that] also may provide evidence relevant to the measurement and disclosure of fair values."[19]

27. Stone failed to comply with these rules and standards in connection with the 2007 ArthroCare audit.

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[15] AU § 316.66.

[16] AU § 316.67.

[17] AU § 328.39, *Auditing Fair Value Measurements and Disclosures*.

[18] AU § 328.03.

[19] AU §§ 328.47, 328.02.

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Stone Failed to Properly Audit Revenue Recognized from Sales to DiscoCare

28. Stone knew that ArthroCare's recognition of revenue from sales to DiscoCare was material to ArthroCare's 2007 financial statements. The increased sales to DiscoCare helped ArthroCare meet its 2007 revenue forecasts.

29. As disclosed in its public filings, ArthroCare recognized revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements* ("SAB 104").[20] SAB 104 establishes that "revenue should not be recognized until it is realized or realizable and earned," which occurs when all of the following criteria are met: (1) "Persuasive evidence of an arrangement exists," (2) "Delivery has occurred or services have been rendered," (3) "The seller's price to the buyer is fixed or determinable," and (4) "Collectibility is reasonably assured." [21] ArthroCare disclosed that "[g]enerally, the [SAB 104] criteria are met upon shipment of the Company's products."[22]

30. In planning the 2007 audit, Stone and his engagement team identified the following "key risk" relating to revenue recognition: "The Company has undergone a period of rapid sales growth in the last two fiscal years, indicating a risk of improper revenue recognition in order to spur sales and meet performance objectives." In the 2007 audit's fraud risk assessment, Stone and his team identified as a risk of "fraudulent financial reporting … that possibly could result in a material misstatement: Improper recognition of revenue due to fictitious sales recorded by the Company in order to increase net sales…."[23] They also identified the following "specific fraud risks" related to ArthroCare's revenue recognition:

> Arthro[C]are Corporation has seen increasing revenues in comparison to prior year quarters and may be under pressure to

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[20] SAB 104 is codified in Topic 13—Revenue Recognition, in the SEC's Codification of Staff Accounting Bulletins.

[21] SAB 104 (Topic 13A1) (footnotes omitted).

[22] ArthroCare Corporation, Form 10-K for the year ended December 31, 2007 (Feb. 29, 2008), at 25.

[23] See AU § 316.41 ("the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition").

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> meet internal and analyst expectations.... The following is our assessment as to opportunities for fraud to occur. The audit risk associated with all items is overstatement of revenues.
>
> 1.) Extended payment terms
> 2.) Fictitious customers and contracts
> 3.) Revenues recognized in improper period.

31. To address the identified risks, Stone and his team planned to perform substantive tests of details relating to ArthroCare's revenue recognition during the 2007 audit. A preliminary audit planning work paper reviewed by Stone identified the following tests of details that his team planned to perform in the revenue area: (1) "Revenue – Agree comparative summary totals to the general ledger"; (2) "Evaluate the accounting policy for revenue recognition"; (3) "Test sales/revenue transactions for proper revenue recognition"; and (4) "DiscoCare CM [i.e., Critical Matter[24]] – evaluate revenue recognition and assess collectibility of receivable."

32. In the final version of the same audit work paper, which was also reviewed by Stone, the team added a Critical Matter regarding ArthroCare's accounting and disclosures for the DiscoCare acquisition, but eliminated the DiscoCare Critical Matter on revenue recognition and collectibility. Stone and his team completed the Critical Matter regarding the DiscoCare acquisition, but did not complete a DiscoCare Critical Matter on revenue recognition and collectibility. Nor did they perform any of the planned detailed testing of sales/revenue transactions for proper revenue recognition during the 2007 year-end audit. Instead, PwC's year-end work papers stated that the "engagement team has determined that no detailed testing of Revenue is necessary due to high controls reliance and the rigor of our substantive analytical procedures."

33. Although Stone's engagement team performed sales cut-off testing during the 2007 first and second quarter reviews and certain analytical procedures, these

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[24] At all relevant times, PwC's internal auditing guidance identified "Critical Matters" as "significant findings or issues" (as that term is defined in PCAOB Auditing Standard No. 3, *Audit Documentation* ("AS 3"), ¶12) and "significant matters" (as discussed in Section 210.2-06 of Regulation S-X). PwC's internal guidance also stated: "Critical matters require appropriate documentation and resolution by the engagement team, timely review and clearance by the engagement leader, and timely review by the quality review partner." AS 3 defines "significant findings or issues" as "substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached." (AS 3, ¶12.)

procedures were not sufficient to test whether revenue recognized from DiscoCare sales met all SAB 104 criteria. Other than a limited assessment of bill and hold criteria during the 2007 first-quarter review, no other substantive procedures were performed to test or otherwise assess whether revenue recognized by ArthroCare on DiscoCare sales was realized or realizable, and earned in accordance with SAB 104, including whether ArthroCare was reasonably assured of collecting on the sales when revenue was recognized. None of the cut-off testing, the analytical procedures, the controls testing, or any of the other audit procedures provided sufficient competent evidence that ArthroCare had complied with SAB 104 in recognizing revenue on its 2007 sales to DiscoCare.

Indicators of Possible Improper Revenue Recognition Concerning DiscoCare Sales

34. Stone knew or should have known of numerous indicators concerning ArthroCare's arrangement with DiscoCare that highlighted the significant and unusual nature of ArthroCare's transactions with DiscoCare and that should have alerted him to the possibility that ArthroCare may have been improperly recognizing revenue on sales to DiscoCare throughout 2007. Indeed, as described below, beginning in late 2006 and continuing until ArthroCare filed its 2007 Form 10-K, there was an accumulation of evidence indicating possible improper revenue recognition for DiscoCare sales, which was or should have been known to Stone when he authorized issuance of PwC's 2007 audit report.

35. Many of these indicators were evidenced in periodic, client-prepared schedules of activity in ArthroCare's accounts receivable from DiscoCare ("DiscoCare Rollforwards"), which Stone requested and received quarterly beginning in July 2007. All of the DiscoCare Rollforwards included, among other things, monthly totals of invoices issued, payment terms, payments remitted by DiscoCare, and service fee amounts deducted from the DiscoCare accounts receivable balance.

DiscoCare's Past-Due Receivable

36. When the 2006 Agreement was executed, ArthroCare had an unpaid receivable from DiscoCare for earlier SpineWand purchases under the parties' prior agreement, more than half of which was past due. In fact, the 2006 Agreement, which Stone received, specifically referenced DiscoCare's unpaid receivable and permitted

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ArthroCare to deduct one-half of the service fees due to DiscoCare against it.[25] The DiscoCare Rollforwards that Stone reviewed during the 2007 quarterly reviews and the 2007 audit showed that the amount past due at the inception of the 2006 Agreement was at least $975,000. They also showed that, after May 2006, DiscoCare made no cash payments to ArthroCare for SpineWand purchases until DiscoCare began receiving service fee payments from ArthroCare.

37. Despite this knowledge, Stone failed to properly evaluate DiscoCare's previous inability to timely pay its obligations in concluding that the Company had properly recognized revenue on sales to DiscoCare in 2007.

DiscoCare Was Charged Substantially Higher Prices for SpineWands

38. Stone knew that the prices at which ArthroCare was selling SpineWands to DiscoCare under the 2006 Agreement were up to five times higher than those charged to other customers, and that those prices varied based on the case-type (i.e., private health insurance, personal injury, and workers compensation, respectively) for which the product would be used.[26] Stone reviewed work papers documenting that the prices charged DiscoCare for SpineWands ranged from $3,000 to $7,500 per unit, compared to $1,400 per unit for other distributors. The work papers also described management representations that "ArthroCare's beneficial pricing arrangement is feasible due to several factors," including, among other things, "selective distribution of products to healthcare professionals who can code cases using [ArthroCare] products … which in turn provides physicians with a near 100% level of success in obtaining reimbursement from insurers."

39. Stone improperly relied on management's representations about this purportedly "beneficial pricing arrangement," which the work papers also noted was unique to ArthroCare's agreement with DiscoCare. He failed to apply the necessary auditing procedures, and to obtain sufficient competent evidential matter, to reasonably conclude that ArthroCare had properly recognized revenue in 2007 on sales to

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[25] Stone was aware that ArthroCare's practice of deducting one-half of the service fee from the DiscoCare outstanding receivable balance continued throughout 2007.

[26] The prices charged to DiscoCare for SpineWands under the 2006 Agreement also were up to five times higher than the prices charged to DiscoCare under the parties' prior agreement.

DiscoCare at varying prices substantially higher than those charged to other SpineWand purchasers.

Substantially Extended Payment Terms Based on Time Required for DiscoCare to Collect from Third Parties

40. The 2006 Agreement provided DiscoCare with extended payment terms ranging from 180 to 360 days, which were up to three times longer than the 120-day terms for DiscoCare's previous SpineWand purchases, and up to twelve times longer than ArthroCare's standard 30-day terms. Stone was aware of DiscoCare's extended payment terms under the 2006 Agreement. In addition, he knew that the overwhelming majority (72 percent) of DiscoCare SpineWand sales under the 2006 Agreement were at the longest (i.e., 360 days) of these extended payment terms.

41. As reflected in the 2007 work papers, ArthroCare's management told Stone and his team that the "collection risk [on DiscoCare's accounts receivable] is low" because (1) a sale is booked when a surgery has already been approved, (2) the extended payment terms are based on the time required for DiscoCare to collect payment, (3) DiscoCare has been paying ahead of schedule, and (4) ArthroCare would be renegotiating with DiscoCare to shorten the payment terms in hopes of lowering DiscoCare's percent of the accounts receivable balance.

42. Thus, Stone knew from management that the extended payment terms were based on "the time required for DiscoCare to collect payment from the insurance companies." Despite this knowledge, Stone failed to properly evaluate whether DiscoCare's ability to meet its obligations to ArthroCare was contingent on its ability to collect reimbursement from third-party payors. Instead, Stone relied on management's representations concerning the purportedly low collection risk, without applying the necessary auditing procedures, and obtaining sufficient competent evidential matter, to conclude that ArthroCare's sales to DiscoCare were reasonably assured of collection at the time revenue was recognized.

DiscoCare Bill and Hold Arrangement and the Change to Recognizing Revenue on Shipment to DiscoCare

43. ArthroCare's original accounting for the 2006 Agreement was, in part, premised on SpineWands being drop-shipped by ArthroCare directly to customers and DiscoCare not holding inventory or reselling products. Stone knew that a March 2007 amendment to the 2006 Agreement changed this arrangement to allow DiscoCare to regularly purchase SpineWands for inventory in advance of approved surgeries. He further knew that ArthroCare and DiscoCare had simultaneously entered into a bill and hold arrangement by which, according to a work paper reviewed by Stone, "ArthroCare

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has agreed to temporarily allow DiscoCare the use of [ArthroCare's] warehousing facilities, under an inventory segregation system," which would permit ArthroCare to recognize revenue upon segregation.

44. As explained in a client-provided memo reviewed by Stone, DiscoCare was negotiating a contract with a third party to provide it with warehousing and shipping services, purportedly to ensure that it had a constant supply of SpineWands. The memo stated that, given the time needed to finalize this arrangement, "DiscoCare has approached ArthroCare about storing their products temporarily in ArthroCare's [warehouse] space." A presentation Stone gave to the Audit Committee showed that ArthroCare's first quarter revenue from bill and hold transactions was $2.9 million. Work papers reviewed by Stone evidenced that this revenue was all recorded in the last 12 days of the first quarter.

45. Stone knew that the bill and hold arrangement remained in place at the end of the 2007 second quarter, at which time ArthroCare still had approximately $2.5 million of segregated DiscoCare bill and hold inventory. He further knew that the bill and hold arrangement ended shortly after the close of the 2007 second quarter, when DiscoCare had established its own warehouse space in Florida to which the remaining bill and hold inventory was shipped and where it then maintained SpineWand inventory. Stone and the engagement team performed substantive testing related to the bill and hold arrangement as part of the first quarter interim review.

46. SAB 104 provides that, in order to recognize revenue from bill and hold transactions, "[t]he buyer must have a substantial business purpose for ordering the goods on a bill and hold basis." [27] PwC's bill and hold work papers document management's representation that DiscoCare had requested the bill and hold to avoid SpineWand supply disruptions. Other work papers also document that ArthroCare's production facility had a one-week holiday shutdown in January 2007 and did not reach full production until the end of that month, but neither set of work papers documented that DiscoCare was aware of the shutdown or that the shutdown had affected supply of SpineWands to DiscoCare. Stone relied on management's representation, without applying the necessary auditing procedures and obtaining sufficient competent evidence at year end to reasonably conclude that recognizing revenue under the arrangement complied with SAB 104. Nor did he properly evaluate whether the business rationale for the bill and hold arrangement suggested that the arrangement may have been entered into to engage in fraudulent financial reporting.

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[27] SAB 104 (Topic 13A3a).

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47. Stone knew about, and concurred in, ArthroCare's decision to recognize revenue on bill and hold sales when the products were transferred to a segregated area of ArthroCare's warehouse facilities, as opposed to when drop-shipped by ArthroCare to customers. After the bill and hold ended, Stone knew about, and concurred in, ArthroCare's decision to similarly recognize revenue when SpineWands were shipped to DiscoCare's Florida warehouse. Other than an assessment of the bill and hold criteria, ArthroCare provided no analysis supporting its revenue recognition conclusions, and Stone and his engagement team did not obtain sufficient competent evidence to support, or independently assess, such conclusions.

<u>ArthroCare's Contradictory Treatment of DiscoCare as a Reseller for Revenue Recognition Purposes, But as an Agent for Purposes of Service Fee Accounting</u>

48. In October 2006, shortly before the 2006 Agreement became effective, ArthroCare provided Stone and the engagement team with a draft memo analyzing the service fee arrangement under EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*, and concluding that the service fees to be paid to DiscoCare should be recorded as operating expenses, and not as reductions to revenue. After independently researching the issue, Stone and the engagement team concluded that if DiscoCare were a net-reporting entity under EITF 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, then DiscoCare would not be acting as a reseller; thus, the service fee arrangement would be outside the scope of EITF 01-09, and the service fees should be treated as an expense. After Stone and the engagement team discussed this with management, ArthroCare updated its memo in November 2006 to include an analysis under EITF 99-19, which determined that DiscoCare was a net-reporting entity and, therefore, not a reseller of ArthroCare's products (<u>i.e.</u>, DiscoCare was effectively ArthroCare's agent), and concluded that "revenue will be recorded when the product is shipped to the customer and monthly the service fee paid to DiscoCare will be recorded in operating expenses." Stone and the engagement team concurred in that conclusion.

49. Under the 2006 Agreement's original terms, DiscoCare did not hold inventory, DiscoCare was precluded from reselling products bought from ArthroCare, and ArthroCare recognized revenue when SpineWands were drop-shipped directly to end-user customers for use in surgical procedures. That arrangement changed when the 2006 Agreement was amended beginning in March 2007. From that point on, DiscoCare began holding inventory like a reseller, and instead of recognizing revenue upon drop-shipment to a customer, ArthroCare recognized revenue when SpineWands were segregated in ArthroCare's warehouse facilities during the bill and hold arrangement, and when SpineWands were shipped to DiscoCare's warehouse after the bill and hold ended. ArthroCare re-assessed its analysis of the service fee arrangement

in light of the 2007 amendments, and determined that DiscoCare's decision to hold inventory did not affect the conclusion that DiscoCare was a net-reporting entity under EITF 99-19, and therefore, "not acting in the capacity of a reseller," and that the service fees should continue to be recorded in operating expenses. Stone and the engagement team reviewed and concurred with these accounting decisions.

50. The practical impact of this accounting treatment was that ArthroCare recognized revenue at the earliest possible time (when product was shipped to DiscoCare or segregated in ArthroCare's warehouse) and at the maximum possible amount (at full invoice price with no reduction in revenue for the service fees). Stone concurred with ArthroCare's accounting conclusions without adequately evaluating or reconciling these accounting conclusions for elements in the same arrangement (i.e., how ArthroCare could simultaneously (1) recognize revenue under SAB 104 as if DiscoCare was a reseller, and (2) account for ArthroCare's service fee payments based on management's conclusion that DiscoCare was an agent for the same transactions).

ArthroCare's Involvement in Determining the Quantity and Price/Type of Products to be Ordered by DiscoCare

51. During the 2007 second quarter field work, Stone and members of his engagement team met with ArthroCare's account manager for DiscoCare (the "ArthroCare Account Manager") and other Company personnel "to follow up on any changes with the Company's DiscoCare procedures as well as [to] formally document[] the ordering and recording process." A memo summarizing the meeting, which was included in work papers reviewed by Stone, noted, among other things, that (1) the ArthroCare Account Manager had "access to review" a DiscoCare-maintained database of patient candidates for surgery (known as "Case Tracker"); (2) DiscoCare contacted insurance companies and pre-approved surgeries based on the patients in the database; (3) the database was updated once surgeries were approved; (4) the ArthroCare Account Manager used a formula based on approved surgeries to calculate how many products DiscoCare needed to order, and at what prices (depending on case-type); and (5) the ArthroCare Account Manager would send that calculation to DiscoCare "who in turn places an order with ArthroCare."

52. Because DiscoCare's monthly purchases purportedly were based on data found in Case Tracker, access to the database by the ArthroCare Account Manager or other ArthroCare employees gave rise to a risk of fraud. By manipulating data in Case Tracker, for example, ArthroCare could have caused DiscoCare to improperly increase its monthly SpineWand purchases to meet ArthroCare's revenue forecasts (a fraud risk identified by Stone). Despite this risk of fraud, Stone never properly assessed the ArthroCare Account Manager's or other ArthroCare employees' access to Case Tracker, or what internal controls, if any, ArthroCare had in place to mitigate this fraud risk.

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Although Stone identified specific fraud risks concerning revenue recognition in improper periods and management pressure to meet internal and analyst expectations, he failed to properly evaluate ArthroCare's involvement in DiscoCare's product ordering process.

<u>Pattern of Quarter-End Spikes in DiscoCare Sales</u>

53. Stone knew about significant spikes in sales to DiscoCare at or near the end of fiscal quarters. For example, a second quarter work paper reviewed by Stone observed that "PwC … noted a spike in [DiscoCare] sales at the end of each quarter (Q1 and Q2 '07)." DiscoCare Rollforwards seen by Stone during 2007 quarterly reviews showed a clear pattern of spikes in DiscoCare sales in the last month of fiscal quarters, a pattern that began even before the 2006 Agreement. From the adoption of the 2006 Agreement through the end of the third quarter of 2007, these schedules showed that sales in quarter-end months averaged $3.3 million, while sales in non-quarter-end months averaged $900,000.

54. Moreover, Stone was aware of the substantially increased volume of SpineWand shipments to DiscoCare near year-end 2007, shortly before ArthroCare acquired DiscoCare. Based on a DiscoCare Rollforward sent to Stone during the 2007 audit, fourth quarter SpineWand sales to DiscoCare totaled nearly $6.5 million, with $4.4 million occurring in December 2007 alone. This year-end spike, along with previous quarter-end spikes, raised a question of whether ArthroCare was using end-of-period DiscoCare sales to meet its revenue forecasts (a fraud risk factor identified by Stone).

55. Stone and his engagement team attributed the sales spike at the end of the first quarter to the "start of the bill and hold agreement," and later accepted certain representations from management about the spike at the end of the second quarter. Although they monitored the monthly and quarterly sales thereafter, Stone and his team failed to properly evaluate the impact of quarter-end sales spikes in concluding that the Company had properly recognized revenue on sales to DiscoCare in 2007.

<u>Evidence Suggesting That ArthroCare Was Funding DiscoCare's SpineWand Purchases through the Service Fees</u>

56. The first DiscoCare Rollforward, received and reviewed by Stone in July 2007, showed that from the inception of the 2006 Agreement in November 2006 through June 2007, DiscoCare paid ArthroCare a total of $1.6 million for SpineWand purchases. The schedule also showed that ArthroCare deducted a total of $2.1 million in service fees from the DiscoCare accounts receivable balance during that same period. As Stone knew from the terms of the 2006 Agreement, however, that $2.1 million

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represented just half of the monthly service fee; the other half (another $2.1 million) was paid in cash directly to DiscoCare. Thus, the schedule provided information indicating that the cash half of the service fees paid to DiscoCare was $500,000 more than ArthroCare received back as payment against the DiscoCare receivable for sales under the 2006 Agreement. A later DiscoCare Rollforward showing activity through the end of September likewise indicated that the cash half of the service fees paid to DiscoCare was more than ArthroCare received back as payment against its receivables for sales under the 2006 Agreement.

57. During the year-end audit, Stone reviewed another DiscoCare Rollforward reflecting activity through December 2007. This schedule provided information indicating that DiscoCare's payments to ArthroCare exceeded the service fee cash payments it received from ArthroCare through year-end. However, Stone knew that, under the terms of the December 31, 2007 DiscoCare acquisition, ArthroCare was required to make a final service fee payment of $2.2 million related to the $4.4 million of SpineWands purchased by DiscoCare in December. As a result, during the audit, Stone possessed information indicating that the cumulative amount of service fees paid in cash by ArthroCare exceeded the total payments made in cash by DiscoCare for SpineWand purchases under both the 2006 Agreement and the parties' earlier agreement.

58. In addition, during the audit, Stone reviewed PwC work papers relating to the DiscoCare acquisition, which showed that, on average, DiscoCare had collected less in third-party reimbursement for the SpineWands than the invoice amounts charged it by ArthroCare. Thus, DiscoCare's history of collections suggested that it lost money on the SpineWands it purchased and resold, and relied on the service fee payments to earn a profit under the 2006 Agreement.[28]

59. This evidence suggested that the service fees ArthroCare paid to DiscoCare—in the form of both direct cash payments and amounts deducted from DiscoCare's receivables balance—may have been funding DiscoCare's obligations to ArthroCare. This evidence—together with other evidence Stone possessed—highlighted the significant and unusual nature of ArthroCare's 2007 selling arrangement with DiscoCare. In light of such evidence, Stone was required to gain an understanding of the business rationale for this arrangement and "whether that rationale (or the lack

[28] Although ArthroCare recognized revenue on the full invoice amounts of SpineWands shipped to DiscoCare, the practical effect of the service fee (which was 50 percent of total monthly invoices) was to offset the invoice amounts owed by DiscoCare by half.

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thereof) suggest[ed] that the [arrangement] may have been entered into to engage in fraudulent financial reporting."[29]

60. Stone failed to reasonably evaluate that business rationale as required by PCAOB standards. Among other things, he failed to properly consider whether DiscoCare had "the substance or the financial strength to support the transaction[s] without [ArthroCare's] assistance," and whether the accounting for the selling arrangement reflected its underlying economic substance.[30] In addition, Stone relied on management representations instead of applying the procedures necessary to properly evaluate the nature of the consulting services that DiscoCare purportedly provided to ArthroCare in exchange for the service fees, and the value received by ArthroCare for such services.

Allegations by Short Sellers and ArthroCare's Chief Medical Officer
Concerning DiscoCare

61. Stone learned no later than early December 2007 that allegations of potential wrongdoing were being made against ArthroCare by short sellers, which focused on the Company's relationship with DiscoCare. These allegations intensified after ArthroCare's acquisition of DiscoCare became public in early January 2008.

62. In response, Stone's engagement team obtained representations that ArthroCare's management had "reviewed the relationships and is confident that their relationships with the doctors['] offices are legal and that these allegations are without merit" and that management was "not aware of any illegal activity." After speaking during the 2007 audit with PwC's local Regional Risk Management Partner about the "short-attack on ArthroCare," Stone told the Quality Review Partner on the engagement that there were "no further actions for our team to take at the present." In connection with the 2007 audit, Stone accepted management's representations regarding the short seller allegations, ultimately concluding that they did not appear to have merit. Neither Stone nor his team performed any additional procedures to specifically respond to the short seller allegations, and, at the completion of the audit, they concluded that "[n]o additional procedures are necessary based on the accumulated results of our auditing procedures."

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[29] AU § 316.66.

[30] AU § 316.67.

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63. On the day before the 2007 audit opinion was issued, Stone became aware that ArthroCare's Chief Medical Officer ("CMO") had resigned because of his "serious concerns about the potential risks posed by the company's growing association with DiscoCare," and because "the DiscoCare model, and the company's increasing reliance on that model, present serious opportunities for abuse by unethical or uninformed individuals." The CMO further stated: "Should such abuse occur, [ArthroCare] could find itself faced with potentially serious allegations of insurance or other fraud."

64. In response to the short seller and CMO allegations, Stone got certain representations from ArthroCare's management, the Audit Committee chair, and outside counsel. But he failed to apply the necessary auditing procedures, and failed to obtain sufficient competent evidential matter, to provide reasonable assurance that the 2007 DiscoCare-related revenue was recognized in compliance with SAB 104.

Stone Failed to Perform Sufficient Audit Procedures Concerning ArthroCare's Accounting for the DiscoCare Acquisition

65. ArthroCare acquired DiscoCare in a stock purchase transaction that closed as of December 31, 2007. Under the acquisition terms, ArthroCare purchased all of the outstanding common stock of DiscoCare for $25 million in cash, plus potential future earn out payments.

<u>Accounting for Settlement of the Pre-Existing Arrangement</u>

66. ArthroCare evaluated the DiscoCare acquisition under EITF 04-01, *Accounting for Preexisting Relationships Between the Parties to a Business Combination*, and concluded that it was not required to record any gain or loss for settlement of the 2006 Agreement. The Company therefore allocated the entire purchase price first to the purported fair market value of the acquired net assets, with the remainder recorded as goodwill.

67. To support its accounting conclusion, ArthroCare prepared a February 2008 memo stating that there was no direct evidence of an "off-market component" related to the 2006 Agreement and that all "indirect evidence" pointed toward the contract being at market value. The indirect evidence cited by the Company included management's belief that, if the 2006 Agreement were up for renewal at the time of the acquisition, "the prices and other significant terms would remain unmodified from the terms of the current contract." However, this representation was contradicted by an earlier management representation that ArthroCare "will be renegotiating with DiscoCare to lower the timing of the payment terms in hopes of lowering DiscoCare's

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[accounts receivable balance]," which was included in 2007 second and third quarter work papers that Stone reviewed. Further, Stone reviewed other PwC work papers concerning the DiscoCare acquisition that showed that DiscoCare was collecting, on average, less than what ArthroCare was charging DiscoCare for each SpineWand, which should have caused Stone to question management's representation that there was no direct evidence of an off-market component in the 2006 Agreement.

68. Stone knew that the 2006 Agreement contained a provision requiring ArthroCare to pay DiscoCare $25 million upon early termination—the same amount as the up-front $25 million cash portion of the acquisition fee. Despite his knowledge of the early-termination fee and evidence that should have caused him to question management representations regarding settlement of the 2006 Agreement, Stone agreed with the Company's decision not to record any gain or loss for settlement of the 2006 Agreement, without adequately assessing whether such accounting treatment complied with GAAP.

<u>Receivables Acquired From DiscoCare</u>

69. Based on the fair values estimated by management, one of the most significant tangible assets acquired by ArthroCare was DiscoCare's accounts receivable, which represented DiscoCare's claims for reimbursement from third party payors for SpineWands used in surgical procedures. ArthroCare valued the acquired receivables at $10.9 million. In auditing the acquired receivables, Stone and his engagement team concluded that confirmations would be ineffective because DiscoCare's receivables were primarily owed by insurance companies. Instead, Stone's team decided to test, based on PwC's sampling guidance, a sample of 19 receivables in an effort "[t]o gain comfort over the existence/occurrence and rights/obligations of DiscoCare's [a]ccounts [r]eceivable balance at year end." Through this testing, Stone and his team sought to validate not only that medical procedures took place, but also that the "company's supporting documentation used to submit collections from the insurance companies is adequate to support the balance."

70. At Stone's request, his then-audit manager sought the assistance of a PwC subject-matter expert "with healthcare compliance expertise to assist the audit team in the review of [DiscoCare] receivables files." A director in PwC's healthcare advisory practice, who "specialize[d] in health care and insurance collections" ("HC Specialist"), was selected to assist Stone and his team in validating the supporting documents for insurance collection, because the "engagement team did not have the benefit of extensive industry expertise" to do so. The HC Specialist's assistance was also sought because "[t]here ha[d] been some recent scrutiny by certain analysts into the company's practices that we believe warrants an increased level of audit procedures on our end."

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71. The HC Specialist reviewed patient file documentation provided to him by ArthroCare for the 19 sampled receivables. In a memo provided to Stone and included in the work papers, the HC Specialist noted: "Overall, there was a lack of consistency in the documentation provided to review the accounts. The lack of consistency was also noted in many data fields that were not populated in the screen shots of the DiscoCare Case Tracker." The HC Specialist also observed that, although he was told by ArthroCare staff that pre-authorizations were required before processing cases involving commercial payors, he found no evidence that pre-authorizations had been obtained. The HC Specialist similarly noted, based on his experience in the healthcare field, that pre-authorizations were required in workers' compensation cases; however, he located no such pre-authorizations in the workers' compensation cases he reviewed. In addition, he found a patient-executed assignment of benefits in only one of the ten cases in which DiscoCare purportedly took such an assignment.

72. The HC Specialist recommended that additional efforts "be made to assess the activity associated with DiscoCare's account follow-up procedures," including that ArthroCare should determine the legal effect of the letters of protection used in connection with personal injury and some auto insurance claims; he noted, based on his experience, that liens are typically filed in the relevant courts to protect the claimant's financial exposure in such cases. The HC Specialist provided no conclusion, based on records and data available to him or otherwise, that the acquired accounts receivable were collectible.

73. After receiving the HC Specialist's memo, Stone knew that his engagement team sought to obtain operative reports evidencing that surgical procedures had, in fact, been performed for each of the 19 sampled receivables. The engagement team obtained such operative reports or alternative documentation for each.[31] The work paper summarizing the engagement team's testing, which was reviewed by Stone, noted that "[a]s a result of testing, all A/R balances selected were verified without exception." However, as Stone knew, the HC Specialist identified numerous exceptions in the documentation supporting the sampled receivables. Stone also knew, or should have known, that neither the HC Specialist's nor the engagement team's work constituted sufficient competent evidence to support the rights and

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[31] As Stone knew, in the four instances where such operative reports were not available, his engagement team obtained either a signed statement from a sales representative who purportedly witnessed the surgery (two instances), or a copy of the UPC code from the box that contained the SpineWand purportedly used in the procedure together with the date the procedures were performed and the names of the patients (two instances).

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obligations assertions for those receivables, or to support their collectibility. Moreover, Stone knew, or should have known, that the operative reports and alternative documentation did not constitute sufficient competent evidence to support all of the financial statement assertions for those receivables, or to support their collectibility, particularly in light of the numerous exceptions noted by the HC Specialist.

74. The HC Specialist's findings also cast doubt on certain management representations made to Stone and his team. ArthroCare management told Stone and his team that Case Tracker was used by the ArthroCare Account Manager to determine the number of SpineWands to be ordered each month by DiscoCare, based on approved surgical cases that were recorded and tracked in the database. Management also represented that a SpineWand sale was booked only after a surgery had been approved. But the HC Specialist found missing Case Tracker data, missing surgery pre-authorizations, and other significant document deficiencies and inconsistencies for most of the 19 sampled receivables he reviewed. Stone did not assess the inconsistency between the HC Specialist's findings and management's representations, nor did he assess the impact of the HC Specialist's findings on ArthroCare's conclusion that revenue it recognized from sales to DiscoCare in 2007 met all SAB 104 criteria, including reasonable assurance of collectibility.

75. In estimating the fair market value of the acquired receivables, ArthroCare determined DiscoCare's average historical collection amounts by case-type of receivables and applied those amounts by case-type to calculate the fair value of the acquired receivables. Stone and his engagement team failed to consider the impact of the HC Specialist's findings on the Company's fair value determinations. Specifically, Stone and his team failed to assess whether the acquired receivables differed from the historical receivables in terms of documentation supporting collectibility, including evidence of pre-authorizations and benefit assignments.

76. Additionally, in determining historical collection amounts, management excluded unpaid receivables owed to DiscoCare by third-party payors that were older than 360 days at the time of acquisition. Although management represented that those receivables were not acquired by ArthroCare, Stone and his engagement team did not properly consider the impact, if any, of their exclusion on the fair value determinations.

E. Stone Failed to Conduct a Reasonable Subsequent Events Investigation Before Consenting to Incorporate PwC's 2007 Audit Report in ArthroCare's June 6, 2008 Form S-8 Registration Statement

77. On June 6, 2008, ArthroCare filed a Form S-8 Registration Statement with the SEC under which the Company registered 1.2 million shares of its common stock for offer and sale under its Amended and Restated 2003 Incentive Stock Plan. The

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Form S-8, made under the Securities Act of 1933, became effective upon its filing. ArthroCare's Form S-8 included PwC's consent to incorporate by reference PwC's February 29, 2008 audit report relating to ArthroCare's 2007 financial statements ("PwC Consent"). In his capacity as the ArthroCare engagement partner, Stone authorized issuance of the PwC Consent on June 6, 2008.

78. PCAOB standards provide that "[w]hen an independent accountant's report is included in registration statements … filed under the federal securities statutes, the accountant's responsibility, generally, is in substance no different from that involved in other types of reporting."[32] Under PCAOB standards, Stone was required to complete a "reasonable investigation" sufficient for him to have a "reasonable ground to believe" that the statements in PwC's 2007 audit report remained true.[33] Stone had to "extend his procedures with respect to subsequent events from the [February 29, 2008] date of his audit report up to the effective date [of the Form S-8] or as close thereto as is reasonable and practicable in the circumstances."[34]

79. If, while performing such subsequent event procedures (or otherwise), the auditor "becomes aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts, he should follow the guidance in [AU §§] 560 and 561,"[35] which provides in pertinent part:

> When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which 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.[36]

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[32] AU § 711.02, *Filings Under Federal Securities Statutes*.

[33] AU § 711.03.

[34] AU § 711.10.

[35] AU § 711.12.

[36] AU § 561.04, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

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80. Stone became aware no later than May 29, 2008 of ArthroCare's intention to file the Form S-8. At the time, Stone understood that a national securities exchange inquiry concerning ArthroCare's relationship with DiscoCare had closed without action based on information provided to the exchange by ArthroCare, and that the Audit Committee had received a report from an outside health care attorney who had examined DiscoCare's business model and found nothing improper in the model. On May 30, 2008, PwC, including Stone, received two anonymous faxes ("May 30th Faxes") containing allegations similar to those Stone learned of and discussed with senior ArthroCare management during the 2007 audit; namely, allegations that DiscoCare's relationships with ArthroCare, insurance carriers, and others were improper. The May 30th Faxes also contained new allegations, including that ArthroCare had purchased DiscoCare because of the rising DiscoCare receivable and ArthroCare's belief that the receivable was not collectible, and that ArthroCare had engaged in "channel stuffing" relating to pre-acquisition sales to a European company acquired by ArthroCare in the second quarter of 2008. The next business day, Stone brought the May 30th Faxes to the attention of ArthroCare's Chief Financial Officer, General Counsel, and Audit Committee Chair.

81. On June 5, 2008, Stone learned that the sender of the May 30th Faxes had spoken by phone that day with an attorney in PwC's Office of General Counsel, and had identified himself as a short seller of ArthroCare's common stock. Also on June 5, 2008, PwC, including Stone, received a third fax from the short seller. The information in the third fax and the phone call (collectively, "June 5th Communications") contained additional details regarding the allegations, including the name of a former ArthroCare employee who allegedly had personal knowledge of certain alleged misconduct. Stone conferred on these matters with the Company's management and counsel, and his Quality Review and National Risk Management Partners, among others.

82. After he conferred regarding the Form S-8 with PwC's National Risk Management Partner, Stone authorized issuance of the PwC Consent on June 6, 2008. When he did so, he was aware of allegations concerning a potential material misstatement of ArthroCare's 2007 financial statements and he knew that management was continuing to assess the allegations. While he had spoken with the Company's management and counsel about the allegations, he was still awaiting management's detailed written response to the allegations in the May 30th Faxes, which he had requested and which he did not receive until the next day. All of this was confirmed in an email he sent to his Quality Review Partner shortly after the Form S-8 was filed, in which he articulated his awareness of the ongoing nature of the inquiries, by both ArthroCare and PwC, concerning the allegations in the May 30th Faxes and the June 5th

Communications.[37] In authorizing the PwC Consent on June 6, Stone failed to obtain sufficient competent evidential matter, failed to exercise the requisite due professional care and professional skepticism, and failed to conduct a reasonable subsequent events investigation sufficient to give him reasonable assurance that ArthroCare's 2007 financial statements were free of misstatement.

83. On July 21, 2008, six weeks after Stone authorized issuance of the PwC Consent, ArthroCare publicly announced that its financial statements for 2007, as well as other periods, could no longer be relied upon and would be restated.

IV.

In view of the foregoing, and to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports, the Board determines it appropriate to impose the sanctions agreed to in Stone's Offer. Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 105(c)(4)(E) of the Act and PCAOB Rule 5300(a)(5), Randall A. Stone is hereby censured;

B. Pursuant to Section 105(c)(4)(B) of the Act and PCAOB Rule 5300(a)(2), Randall A. Stone is barred from being an associated person of a registered public accounting firm, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i);

C. After three (3) years from the date of this Order, Randall A. Stone may file a petition, pursuant to PCAOB Rule 5302(b), for Board consent to associate with a registered public accounting firm; and

D. Pursuant to Section 105(c)(4)(D) of the Act and PCAOB Rule 5300(a)(4), a civil money penalty in the amount of $50,000 payable by Randall A. Stone is imposed. All funds collected by the Board as a result of the assessment of this civil money penalty will be used in accordance with Section 109(c)(2) of the Act. Randall A. Stone shall pay this civil money

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[37] Stone's engagement team performed certain subsequent events procedures relating to the Form S-8, including reading the latest interim financial statements and making inquiries of management. However, none of the engagement team's subsequent events work adequately addressed the allegations contained in the May 30th Faxes and the June 5th Communications.

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penalty within 10 days of the issuance of this Order by (a) wire transfer in accordance with instructions furnished by Board staff; or (b) United States postal money order, certified check, bank cashier's check or bank money order; (c) made payable to the Public Company Accounting Oversight Board; (d) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006; and (e) submitted under a cover letter which identifies Randall A. Stone as a Respondent in these proceedings, sets forth the title and PCAOB Release 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 the Office of the Secretary, Attention: Phoebe Brown, Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006.

ISSUED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

July 7, 2014