

MEMO# 20719

December 21, 2006

SEC Sanctions Auditor in Connection with Mutual Fund Audits

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20719] December 21, 2006 TO: ACCOUNTING/TREASURERS MEMBERS No. 31-06 COMPLIANCE MEMBERS No. 53-06 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 9-06 RE: SEC SANCTIONS AUDITOR IN CONNECTION WITH MUTUAL FUND AUDITS The Securities and Exchange Commission recently issued an order making findings and imposing remedial sanctions pursuant to Rule 102(e) of the Commission's Rules of Practice against a certified public accountant ("Respondent") in connection with his audits of a money market fund and a bond fund.¹ The Respondent consented to the entry of the SEC Order without admitting or denying the SEC's findings. The action involved allegations that the Respondent engaged in improper professional conduct by allowing his firm to issue audit reports with an unqualified opinion falsely representing that the funds' financial statements were prepared in conformity with generally accepted accounting principles ("GAAP") and that the audits were conducted in accordance with generally accepted auditing standards ("GAAS"). Findings During the audit of the money market fund the Respondent became aware that more than half of the securities in the money market fund's portfolio had stated maturity dates exceeding the 397 day period set forth in Investment Company Act Rule 2a-7. The Respondent, who was the concurring review partner on the engagement, failed to ensure that the engagement partner performed audit procedures to determine whether the securities were in fact eligible for a money market fund or to otherwise test the fund's compliance with Rule 2a-7. As a result, the Respondent failed to detect that the fund's financial statements and related notes contained material misrepresentations, including that 1 See In the Matter of James T. McCurdy, CPA, SEC Release No. 34-54945, Accounting and Auditing Enforcement Release No. 2525, Administrative Proceeding File No. 3-12322 (December 15, 2006) ("SEC Order"). Copies of the SEC Order are available on the SEC's website at <http://www.sec.gov/litigation/admin/2006/34-54945.pdf>. 2 the fund was a "money market fund" and that it was proper for the fund to use the amortized cost method to value its portfolio securities. The Respondent also engaged in improper professional conduct during the audits of a bond fund's financial statements for the years ended October 31, 1999 and October 31, 2000. The 1999 audit failed to detect (i) that the fund was over-accruing interest for bonds that had missed interest payments, were in default, or had previously been sold and were no longer held by the fund; (ii) that a significant portion of the fund's interest receivable balance was uncollectible; and (iii) that the fund's financial statements were not fairly presented in conformity with GAAP. The uncollectible interest was included in the fund's trial balance and used to compute the fund's daily net asset value for at least six months, during which time the net asset value was overstated by between \$.01 and

\$.34 per share. The overstated interest receivable balance came to light during the 2000 audit. As a result of the discovery, the fund was re-priced, the fund wrote off the uncollectible interest, and it was determined that the fund made a return of capital that had not been disclosed to shareholders. None of these events was disclosed in the October 31, 2000 financial statements. Furthermore, despite knowing that a portion of the interest the bond fund wrote off during the fiscal year ended October 31, 2000 related to the prior fiscal year, the Respondent did not take any steps to determine whether the bond fund should restate its financial statements for prior periods. As a result of the conduct described above the SEC Order found that the Respondent engaged in improper professional conduct pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice in connection with the audits of the money market fund and the 1999 and 2000 audits of the bond fund. The Respondent consented to a finding that he engaged in improper professional conduct and a prohibition from appearing or practicing before the Commission as an accountant, with a right to apply for reinstatement after three years. Gregory M. Smith Director - Operations/Compliance & Fund Accounting

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