U.S. Securities and Exchange Commission

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Securities Exchange Act of 1934
Release No. 47900 / May 22, 2003

Accounting and Auditing Enforcement
Release No. 1787 / May 22, 2003

Administrative Proceeding
File No. 3-11132

In the Matter of **PricewaterhouseCoopers LLP,** **Respondent**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against PricewaterhouseCoopers LLP ("PwC" or "Respondent") pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Respondent and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[2] that:

Respondent

PricewaterhouseCoopers LLP is a national public accounting firm with its headquarters in New York, New York. Before the merger between Price Waterhouse LLP and Coopers & Lybrand LLP on July 1, 1998, Price Waterhouse LLP provided audit services to SmarTalk TeleServices Inc.

("SmarTalk"), including performing the annual audit of SmarTalk's 1997 financial statements. After the merger, the combined entity of PwC continued to provide audit services to SmarTalk, including performing the audit of SmarTalk's restated financial statements.[3]

Other Relevant Person and Entity

Philip G. Hirsch ("Hirsch"), age 50, was the engagement partner on the PwC audits of SmarTalk's financial statements from 1996 through March 1998.[4] During that period, he was also the managing partner of PwC's Century City office. He is licensed as a CPA in the state of California. Hirsch was employed by PwC from 1976 to 1978, from 1983 to about 1985 and from 1987 through March 31, 1998. Hirsch left PwC in April 1998 after the audit of SmarTalk's 1997 financial statements was completed.

SmarTalk was a provider of prepaid telephone cards and wireless services that went public in October 1996. During the relevant period, SmarTalk's stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and was listed on the NASDAQ National Market. In November 1998, as a result of some of the accounting issues discussed in this Order, as well as other issues, SmarTalk restated its financial statements for its year ended December 31, 1997 and its first two quarters of 1998.[5] When all of the restated items are taken into consideration, net losses at year-end 1997 decreased from $61.9 million to $25.7 million, net losses for the first quarter of 1998 increased from $3.4 million to $15.2 million, and net income of $2.2 million for the second quarter of 1998 changed to a net loss of $29.2 million.

On January 19, 1999, SmarTalk filed for Chapter 11 bankruptcy and trading in SmarTalk stock was halted. In March 1999, SmarTalk sold substantially all of its assets to AT&T. Since that time, SmarTalk has been liquidating its remaining assets in the bankruptcy proceeding.

Summary

SmarTalk filed with the Commission an annual report on Form 10-K, which contained materially false and misleading financial statements for its year ended December 31, 1997. In the 1997 annual report, SmarTalk reported a one-time charge, a $25 million restructuring reserve, purportedly for anticipated 1998 costs, after its purchase of six other prepaid telephone card businesses. As a result of the acquisitions, SmarTalk obtained additional offices, employees and carrier service providers, as well as prepaid telephone cards with different logos. The entire restructuring reserve did not conform to Generally Accepted Accounting Principles ("GAAP") because the anticipated costs were not proper restructuring costs and the company had failed to properly establish a plan of restructuring in conformity with Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) ("EITF 94-3"). SmarTalk also improperly understated current period operating expenses by charging 1997 operating expenses against the non-GAAP restructuring reserve. This enabled SmarTalk to falsely inflate earnings before one-time charges at year-end 1997.

PwC and Hirsch, the engagement partner on the PwC audit team, audited the financial statements that were contained in SmarTalk's 1997 Form 10-K. However, PwC and Hirsch failed to comply with Generally Accepted Auditing Standards ("GAAS") in the conduct of the audit.

In late-July and early-August 1998, after Hirsch left the firm, PwC reviewed the working papers for its audit of SmarTalk's 1997 financial statements in contemplation of resigning as SmarTalk's auditor. During its review of the working papers, PwC identified potential issues with SmarTalk's 1997 financial statements and its audit. As set forth more fully below, PwC made undocumented changes to its 1997 audit working papers and discarded other documents relevant to its audit.[6]

On August 10, 1998, SmarTalk announced that its auditors had informed management about potentially significant issues with SmarTalk's accounting treatment for acquisitions that occurred during 1997 and certain other items relating to fiscal year 1997. On August 11, after the press release, SmarTalk's stock price fell 57%, from $16 5/8 to $7 5/32.

In November 1998, SmarTalk restated its financial statements for year-end 1997, as well as its first two quarters of 1998. In the restatement, SmarTalk reversed the entire $25 million restructuring reserve that had been recorded at year-end 1997. In addition, SmarTalk expensed most of the operating costs that had previously been charged against the restructuring reserve.

PwC's and Hirsch's conduct constituted improper professional conduct for purposes of Commission Rule of Practice 102(e).

Year-End 1997: SmarTalk Establishes a Non-GAAP Restructuring Reserve and Overstates Net Income Before One-Time Charges

In its year-end 1997 financial statements, SmarTalk recorded a one-time charge, a $25 million restructuring reserve. As reflected in SmarTalk's Form 10-K and restructuring reserve schedules given to PwC, the $25 million restructuring reserve consisted of five types of costs purportedly to be incurred in 1998 in order to exit certain activities: contract termination fees; write-down of prepaid card inventory that would be recalled in 1998; certain asset write-downs; severance benefits associated with personnel reductions in 1998; and various general reserves. SmarTalk failed to follow through on most of its restructuring plan and therefore incurred few of the costs for which it had reserved.

Glen Andrew Folck,[7] SmarTalk's Chief Financial Officer (the "CFO") consulted with Hirsch in the course of establishing the restructuring reserve. Also, Hirsch arranged for the CFO to be given a copy of EITF 94-3, which applies to certain costs incurred in restructuring.

At the beginning of the audit of SmarTalk's 1997 financial statements, PwC assessed the risks of SmarTalk engaging in fraudulent accounting and reporting. Specifically, in January 1998, Hirsch signed a risk assessment form in which a PwC audit staff member had identified certain risks potentially affecting the audit, including: SmarTalk management had an excessive interest in maintaining or increasing SmarTalk's stock price or earnings trend through the use of unusually aggressive accounting practices; SmarTalk had an inability to generate cash flows from operations while reporting earnings and earnings growth; some of SmarTalk's estimates involved unusually subjective judgments or uncertainties or were subject to potential significant change in the near term; and SmarTalk's staff was weak in financial/SEC reporting. In view of these known risks, Hirsch should have exercised more skepticism and obtained more evidence from management to support PwC's audit opinion on the financial statements. Instead, as set forth below, Hirsch did not ensure that sufficient audit procedures were conducted. While management had provided a written representation to PwC that GAAP had been applied in the preparation of the financial statements for the year ended December 31, 1997, as described below, Hirsch was aware of other audit evidence from which he should have realized further audit work was required.

PwC and Hirsch Failed to Adequately Test Management's Commitment to a

Detailed Exit Plan Prior to Year-end 1997

To establish a restructuring reserve, EITF 94-3 required SmarTalk management to approve and commit the enterprise to an exit plan by the date of the financial statements (in this case December 31, 1997). An exit plan must specifically identify all significant actions to be taken to complete the exit plan, activities that will not be continued, including the method of disposition and location of those activities, and the expected date of completion. EITF 94-3 also provides that a liability should be recognized at the commitment date (by December 31, 1997) for only those exit costs that can be reasonably estimated.

SmarTalk had no detailed plan or proper approval in 1997. At the end of October 1997, some elements of a plan, but not the details or the amounts, were discussed at a board of directors meeting. By late December 1997, the CFO developed a list of potential restructuring reserve costs. Nevertheless, that list was not finalized and the amounts and other details, including the timing of activities to be discontinued, were not determined in 1997. Rather, in January 1998, the CFO began getting input from SmarTalk employees to prepare a more detailed schedule of restructuring reserve items and to derive amounts. In January 1998, the CFO compiled a first draft schedule of restructuring reserve amounts and presented the draft schedule to PwC.

Later in 1998 the CFO's schedule of restructuring items went through several subsequent revisions, when the exit plan should have been completed and amounts estimated by December 31, 1997. There were material changes in the nature, amounts and timing of many items in the several versions of the restructuring reserve schedules in 1998. The changes to the plan in 1998 reflect SmarTalk's failure to commit to a restructuring plan in conformity with EITF 94-3 and inability to make reliable estimates by year-end 1997. In view of the failure to commit to a detailed exit plan prior to year-end, any approval in 1997 was too limited and any approval in 1998 was too late.

Hirsch was aware of information which should have made him question whether SmarTalk had committed to a detailed plan and estimated amounts by December 31, 1997. For example, in late November or early December 1997, the CFO told Hirsch that SmarTalk had not yet completed its plan or finalized the amounts. It was not until January 1998 that Hirsch and other PwC staff were first given the CFO's draft schedule of restructuring reserve amounts.

Later in January 1998, a PwC audit staff member provided Hirsch with an analysis (the "January 1998 Memorandum") of the CFO's draft restructuring reserve schedule. The January 1998 Memorandum, which was not made part of PwC's working papers, evaluated the propriety of the components of the proposed restructuring reserve based on information available at the time. Among other things, the January 1998 Memorandum disclosed that the timing of the two carrier contract terminations had not yet been decided and the timing of these events would affect the amounts reserved. The January 1998 Memorandum further stated that the following were issues with the prepaid card inventory: the timing of the recall of prepaid card inventory would affect the amount reserved and the "cost of [the] recall [was] difficult to determine." The amounts ultimately reserved for these items totaled more than $17 million of the $25 million restructuring reserve.

In February and March 1998, PwC was given two subsequent versions of the restructuring reserve schedules, which reflected material changes to the amounts to be reserved for various components. For example, the amount estimated for one of the contract terminations increased from $5 million in January to $8.4 million in February and then to $9.7 million in March. As noted above, the changes to the plan in 1998 reflect SmarTalk's failure to commit to a restructuring plan in conformity with EITF 94-3 and its inability to make reliable estimates by year-end 1997.

At the end of March 1998, SmarTalk management signed a letter to PwC which contained certain representations ("Management Representation Letter"). In the Management Representation Letter, SmarTalk's management represented that SmarTalk was "committed to its plan of restructure to be executed during the year ended December 31, 1998." The Management Representation Letter does not state, however, that SmarTalk had committed to the plan in 1997.

In view of the foregoing information that PwC and Hirsch knew, they should have raised questions concerning management's commitment to a detailed plan by year-end 1997. Therefore, PwC and Hirsch failed to adequately test management's commitment to a detailed plan in 1997. PwC and Hirsch failed to obtain sufficient documentary support or a sufficient written representation indicating that management had committed to a detailed exit plan by year-end 1997.

PwC and Hirsch Failed to Adequately Audit the Reserve for Contract Termination Fees

The largest component of the reserve was $13.5 million for commitments and penalties pertaining to contracts that were ostensibly to be terminated in 1998. Most of this component was for amounts due upon termination of SmarTalk's carrier services with WorldCom and MCI.[8] In SmarTalk's 1997 Form 10-K, SmarTalk stated that its restructuring plan included consolidating its transport provider base from approximately seven to two carriers. In addition, SmarTalk management represented that the company intended to switch its carrier traffic from WorldCom and MCI to Frontier Communications at some point in 1998, due to more favorable rates on the Frontier contract. Moreover, the management representation letter stated that SmarTalk would not utilize traffic volume commitments (other than those estimated to be used through March 31, 1998) with MCI or WorldCom, and management did not believe that these commitments could be sold, transferred or otherwise assigned to a third party or that any of the costs to be incurred under existing agreements would be recouped. However, only some traffic was ever switched to Frontier, in part, because of technical difficulties in 1998. Also, the switch of traffic occurred later in 1998 than had been reflected in SmarTalk's restructuring schedules, which had been provided to PwC. SmarTalk continued to use the MCI contract through its bankruptcy in 1999 and assigned its interest in the WorldCom contract to another company in mid-1998.

While Hirsch considered the contracts to be adverse purchase commitments, PwC and Hirsch should have known that the contract termination costs were not exit costs under EITF 94-3. SmarTalk was switching one contract for another and thus, the termination costs were associated with activities that would be continued, which would not satisfy the requirements of EITF 94-3.

In addition, PwC and Hirsch should have known that SmarTalk had no reasonable basis for accrual of these costs under Statement of Financial Accounting Standards ("SFAS") No. 5, Accounting for Contingencies. SFAS No. 5 requires that losses associated with contingencies be accrued only if it is probable that a liability had been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. Hirsch knew that SmarTalk management intended to and did continue to use the carrier contracts in the early part of 1998. Hirsch also knew that SmarTalk had not notified MCI or WorldCom prior to December 31, 1997 of its intention to terminate the contracts. Accordingly, Hirsch should have known that no events had occurred that would have obligated SmarTalk as of year-end 1997 to pay termination costs. Moreover, Hirsch was informed that, by year-end 1997, SmarTalk management had not determined the timing of the contract terminations and the timing of those events would and did affect the amount reserved for the WorldCom contract. Accordingly, Hirsch should have known that at year-end management was unable to reasonably estimate how much the penalties under that contract would be.

PwC and Hirsch Failed to Adequately Audit the Reserve for Inventory Write-Downs

Another component improperly included in the restructuring reserve was $4.5 million for inventory of prepaid telephone cards that were to be recalled from customers, discarded and replaced some time in 1998 with cards containing a new SmarTalk logo. The Management Representation Letter stated that SmarTalk "will dispose of obsolete inventory as part of the restructure." The prepaid card inventory, however, was not recalled or destroyed and SmarTalk continued selling some of the cards.

PwC and Hirsch were aware that inventory write-downs are specifically addressed in Emerging Issues Task Force Issue No. 96-9, Classification of Inventory Markdowns and Other Costs Associated with a Restructuring, which contains the Commission's view that write-downs of inventory should be reflected as costs of goods sold. The January 1998 Memorandum that was provided to Hirsch noted the Commission's view.

PwC and Hirsch also should have known that SmarTalk had no reasonable basis for accruing these costs as a loss at year-end under SFAS No. 5. Hirsch was aware that SmarTalk continued to sell its inventory on hand in 1998. Hirsch also was aware that SmarTalk was unable to replace its existing inventory until it had developed a new logo and that had not occurred by year-end 1997 or even as of the end of the audit in 1998. In addition, some of the inventory that was ultimately to be discarded had not even been manufactured by year-end. Thus, PwC and Hirsch should have known that the assets had not been impaired by the end of 1997. Additionally, as noted above, Hirsch was informed in the January 1998 Memorandum that the timing of the product recall would affect the amount reserved and the cost of the recall was difficult to determine. Accordingly, while SmarTalk management estimated the value of the cards that would be discarded based on the amount of inventory on hand at year-end 1997, PwC and Hirsch should have known that the amount of anticipated losses from the eventual destruction of inventory was not reasonably estimable by December 31.

PwC and Hirsch Failed to Adequately Audit the Reserve for Asset Write-Downs Associated with Offices Purportedly to be Closed in 1998

The restructuring reserve also improperly included $3.5 million for assets to be disposed of when SmarTalk closed certain offices in 1998. The Management Representation Letter stated that SmarTalk's "closure of several offices and sites and the relocation of its corporate office will result in lease penalty payments and the possibility of impairment in value of specific assets exists and recovery of the cost thereof is uncertain." However, SmarTalk did sublease its corporate office and the sublease was made effective as of April 1, 1998. SmarTalk also subleased another office.

For the losses on asset impairments, EITF 94-3 defers to SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived

Assets to be Disposed Of ("SFAS No. 121"). The January 1998 Memorandum stated that under SFAS No. 121, losses on asset write-downs are to be reported as a component of income from continuing operations. In addition, Hirsch should have known that these assets did not meet the criteria for asset impairments or asset disposals at December 31, 1997. Moreover, the possibility of impairment and uncertainty of recovery of costs would not, without additional information, support a reserve being established. Accordingly, PwC and Hirsch should have known that the reserve for asset write-downs was improper.

PwC and Hirsch Failed to Adequately Audit the Reserve for Severance Benefits

The fourth component of the restructuring reserve improperly included $1.1 million for severance benefits for employees, at offices to be closed and at SmarTalk's new headquarters, whose employments were to be terminated in 1998. For involuntary severance benefits to be included in the reserves as of December 31, 1997, EITF 94-3 required management, prior to year-end, to identify the number of employees to be terminated, their job classifications and locations, establish the benefits employees will receive upon termination and communicate the benefit arrangement to employees. SmarTalk did not comply with these requirements.

The Management Representation Letter stated, "[e]mployees to be terminated as a result of the restructure plan have been identified and notified of the restructure plan as of December 31, 1997, including benefits to be paid under termination agreements." However, the severance benefit arrangement for most employees was not decided upon until 1998 and employees did not learn the amount of their severance benefits until they were actually terminated (which for most employees was in 1998). In addition, there was no determination in 1997 of the total number of employees to be terminated. Moreover, SmarTalk did not terminate a number of the employees identified on schedules provided to PwC nor pay the amount of severance benefits reflected on those schedules.

PwC and Hirsch should have known that SmarTalk did not comply with EITF 94-3 in reserving for severance benefits. The January 1998 Memorandum informed Hirsch, "Although employees were aware of reductions to come, no specific identification of employees or communication of benefits was made until post [year-end] . . . and [s]ome employees are yet to be informed." In view of this information, Hirsch did not obtain sufficient documentation or a sufficient written management representation showing that employees had been identified or that benefits had been communicated prior to December 31, 1997.

PwC and Hirsch Failed to Adequately Audit SmarTalk's Establishment of General Reserves

The restructuring reserve improperly included $1.8 million of general reserves. The general reserves consisted of: $575,000 for computer conformity, utilities and taxes; $625,000 for travel and telephone expenses related to employee terminations; an overstatement by $180,000 of the MCI contract termination amount; an overstatement by $180,000 of the amount set aside for inventory write-downs; and $250,000 for "various employee severances," for which SmarTalk management failed to identify the number of employees, their job classifications and their locations, as is required under EITF 94-3. SFAS No. 5, paragraph 14, prohibits the accrual of general reserves. Accordingly, these costs were operating expenses that should not have been recorded until they were incurred. PwC and Hirsch posted some of the general reserves to the effects schedule and considered them to be immaterial in light of offsetting adjustments identified in the effects schedule. Nevertheless, PwC and Hirsch knew, or should have known, that general reserves were wrongly included in the restructuring reserve.

PwC and Hirsch Failed to Adequately Audit the Improper Charging of 1997 Operating Expenses Against the Restructuring Reserve

SmarTalk's restructuring plan contemplated that SmarTalk would incur the previously described categories of costs in 1998. Nevertheless, SmarTalk improperly charged a total of $1.06 million of 1997 operating expenses against the restructuring reserve at year-end 1997. The expenses, which were not contemplated by the restructuring plan, included executive travel and entertainment costs, telephone and moving expenses, and consulting fees. Most of the operating expenses charged against the restructuring reserve as of year-end 1997 were incurred in the third quarter of 1997. If the total operating expenses charged as of December 31, 1997 had been properly reflected on SmarTalk's financial statements, earnings before one-time charges would have been reduced from $2.3 million to $1.2 million. In SmarTalk's restated financial statements, most 1997 charges against the restructuring reserve were reversed and reclassified as operating expenses.

SmarTalk's Form 10-K for fiscal year 1997 failed to describe the types and amounts of costs charged against the liability in 1997, as required by EITF 94-3. Instead, SmarTalk reflected these charges on its balance sheet by reducing the total restructuring reserves ($25 million) by the total amount charged as of year-end 1997 ($1.06 million). Although the reduced restructuring reserve amount on the balance sheet reflected use of the reserve in 1997, the reduced restructuring reserve amount on the balance sheet was not explained anywhere in the Form 10-K. Had the costs been described in SmarTalk's Form 10-K, as was required, the misuse of the restructuring reserve in 1997 would have been apparent.

A review by PwC and Hirsch of SmarTalk's restructuring reserve account would have revealed that SmarTalk had already improperly charged expenses against the restructuring reserve in 1997, when the restructuring reserve had been established for expenses purportedly to be incurred in 1998. PwC had access to SmarTalk's accounting records and PwC accounting staff was aware that there were charges to the restructuring reserve in 1997. In addition, the January 1998 Memorandum stated that some costs to be included in the restructuring reserve were "probably incurred pre 12/31." In view of all of the information that PwC and Hirsch knew and had access to, PwC and Hirsch failed to adequately audit the amounts charged against the restructuring reserve at year-end 1997.

Working Paper Alteration and Other Events

At the end of March 1998, after the audit of SmarTalk's 1997 financial statements was completed, Hirsch left PwC. In April and May 1998, audit staff completed the working papers relating to the audit. Then, in May 1998, Hirsch signed the working papers stating that all substantive matters had been completed and the issuance of PwC's audit report was appropriate. In addition, in May 1998, PwC staff signed-off that the working paper files had been completed. Several months later, PwC was considering resigning as SmarTalk's auditors because its relationship with SmarTalk had become contentious. PwC's possible resignation prompted PwC to conduct a post-audit review of the working papers it prepared in connection with its 1997 audit. The post-audit review began on July 18, 1998. The PwC post-audit reviewer identified potential issues with SmarTalk's year-end 1997 financial statements, as well as the audit. In late-July 1998, PwC became aware of a class action shareholder lawsuit alleging accounting fraud against SmarTalk and certain of its officers and directors. At that time, PwC was not named as a defendant in that lawsuit.[9]

During the period from the end of July through early August 1998, with the knowledge of several PwC partners with firm-wide responsibilities, PwC made revisions to its working papers. Those revisions were not documented. Language in the working papers was revised, added and deleted. Documents were removed from the working papers and discarded, and documents were also added to the working papers. The post-audit revisions were not dated or otherwise distinguished to indicate that they had been made as part of a post-audit review and PwC discarded most of the notes containing a second post-audit reviewer's instructions. In addition, during this period, PwC deleted and discarded most of its "desk files."[10] At the time of PwC's conduct, there was no SEC investigation of SmarTalk's accounting or financial disclosures.

On August 7 and August 10, 1998, PwC informed SmarTalk of its concerns with the restructuring reserve and other accounting issues and of the need to restate SmarTalk's financial statements. On August 10, 1998, SmarTalk announced that its auditors had informed management about potentially significant issues with SmarTalk's accounting treatment for acquisitions that occurred during 1997 and certain other items relating to fiscal year 1997. In November 1998, SmarTalk issued restated financial statements for fiscal year 1997 and the first two quarters of 1998.

PwC and Hirsch Engaged in Improper Professional Conduct Within the Meaning of Commission Rule of Practice 102(e)

PwC and Hirsch Failed to Maintain an Attitude of Professional Skepticism

An auditor is required to exercise professional skepticism when performing audit procedures and gathering and analyzing audit evidence. AICPA Codification of Statements on Auditing Standards ("AU") Section 230.07.

Based on the foregoing, in connection with its audit of SmarTalk's 1997 year-end financial statements, PwC and Hirsch failed to maintain the attitude of professional skepticism required by GAAS concerning SmarTalk's accounting for its establishment of and charges against the restructuring reserves. PwC and Hirsch did not follow up on certain information, including the reduced restructuring reserve amount on the balance sheet which reflected the improper charging of 1997 operating expenses against the restructuring reserve that was purportedly established for 1998 costs. Furthermore, in some instances, PwC and Hirsch accepted uncorroborated representations of SmarTalk's management in lieu of performing additional audit procedures, in contravention of AU Section 333. For example, in the Management Representation Letter, management represented that GAAP had been applied in the preparation of the financial statements for the year ended December 31, 1997. However, as described above, this representation was contradicted by other audit evidence PwC and Hirsch obtained. "[R]epresentations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU Section 333.02.

PwC and Hirsch Failed to Obtain Sufficient Competent Evidential Matter

In conducting an audit, an auditor must obtain sufficient competent evidential matter through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit. AU Sections 150.02 & 326.01.

Based on the foregoing, in connection with SmarTalk's year-end 1997 financial statements, PwC and Hirsch failed to obtain sufficient competent evidence (including sufficient management representations) in support of SmarTalk's accounting for its establishment of each component of the restructuring reserve and its charging 1997 expenses against the restructuring reserve that purportedly had been established for anticipated 1998 expenses.

PwC and Hirsch Failed to Exercise Due Professional Care

Auditors must exercise due professional care in performing the audit and preparing the audit report. AU Sections 150.02 and 230.01.

Based on the foregoing, in connection with the audit of SmarTalk's 1997 year-end financial statements, PwC and Hirsch failed to exercise due professional care by failing to plan and perform audit procedures necessary to afford a reasonable basis for PwC's audit opinion. As described above, PwC and Hirsch identified a number of risk factors associated with the preparation of SmarTalk's financial statements. Despite PwC's and Hirsch's awareness of numerous risks and other information that could materially impact the financial statements, PwC and Hirsch failed to perform sufficient audit procedures to assess properly whether SmarTalk's accounting for and charges against its restructuring reserves was in conformity with GAAP. As a result, SmarTalk improperly established a non-GAAP restructuring reserve and, as described above, misused it to materially inflate earnings before one-time charges at year-end 1997.

PwC and Hirsch Failed to Render an Accurate Audit Report

In conducting an audit, an auditor is required to state in the auditor's report whether, in the auditor's opinion, the financial statements are presented in all material respects in conformity with GAAP. AU Sections 410 and 411. An auditor may express that the financial statements are presented in conformity with GAAP only when the auditor has formed such an opinion on the basis of an audit performed in accordance with GAAS. AU Section 508.07.

Based on the foregoing, in connection with the audit of SmarTalk's year-end 1997 financial statements, PwC and Hirsch failed to render an accurate audit report when they stated that SmarTalk's financial statements had been prepared in conformity with GAAP and the audit had been performed in accordance with GAAS. In fact, the financial statements were not in conformity with GAAP, and the audit was not performed in accordance with GAAS.

PwC's Responsibility

The failures of Hirsch, a PwC engagement partner and managing partner of PwC's Century City office, to comply with GAAS in the conduct of the audit bind and are imputed to PwC. Furthermore, it is appropriate to sanction and seek other relief from PwC for the audit failures because PwC, as set forth more fully above, made undocumented changes to its 1997 audit working papers and discarded other documents relevant to its audit.

Findings and Undertakings

Based on the foregoing, the Commission finds that PwC, through Hirsch in connection with the audit of SmarTalk's 1997 financial statements, engaged in improper professional conduct pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice. Specifically, PwC engaged in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards.

Respondent undertakes:

1. within 10 days of the date of this Order, to pay $1,000,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies PwC as a Respondent in these proceedings, the file number of these proceedings, copies of which cover letter and money order or check shall be sent to Antonia Chion, Division of Enforcement, Securities and Exchange Commission, 450 5th Street NW, Washington, DC 20549-0801 and to Lisa Deitch, Division of Enforcement, Securities and Exchange Commission, 450 5th Street NW, Washington, DC 20549-0707.

2. to establish and maintain policies and procedures to preserve working papers intact following the archiving of the working papers and also during the course of, and following the conclusion of, any post-audit review. Such policies and procedures shall require that, to the extent PwC determines that it is necessary to make alterations or additions to the working papers, such alterations or additions will be properly documented, will indicate the time and circumstances under which they are made, and will be made in such a manner so as to preserve the original language of the working papers and the original documents included in the working papers. Within three months of the date of this Order, PwC shall certify in writing to the Commission that such policies and procedures have been established and implemented; and

3. after PwC certifies to the Commission that the policies and procedures set forth in paragraph 2, above, have been established and implemented, to retain, at PwC's expense, an independent consultant or consultants (the "Consultant") not unacceptable to the staff of the Commission. PwC shall require the Consultant to: (1) confirm that PwC has disseminated firm-wide, the policies and procedures referenced in paragraph 2, above; (2) conduct a review of a one-year period beginning three months from the date of this Order (the "Review Period") of any instances in which electronic working papers relating to public companies are unarchived; and (3) review PwC's software system to confirm that it is designed to meet the objectives of the policies and procedures referenced in paragraph 2, above. PwC shall require the Consultant, no later than six months after the end of the Review Period, to complete its review and simultaneously submit a written report documenting its findings to PwC, the Commission and the Public Company Accounting Oversight Board. In addition, PwC shall require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with PwC, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in performance of his/her duties under this Order shall not, without prior written consent of the

Commission's staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with PwC, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

In determining whether to accept the Offer, the Commission has considered the undertakings set forth in paragraphs 1 through 3, above.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, IT IS HEREBY ORDERED, effective immediately, that PwC is censured pursuant to Rule 102(e)(ii) of the Commission's Rules of Practice.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1 Rule 102(e)(1)(ii) provides, in relevant part, that:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . any person who is found . . . to have engaged in . . . improper professional conduct.

2 The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

3 In this Order, "PwC" refers to Price Waterhouse LLP before the merger and to PricewaterhouseCoopers LLP after the merger.

4 Concurrent with the settlement of this matter by PwC, the Commission issued a settled Order Instituting Public Administrative Proceedings in the Matter of Philip Hirsch.

5 PwC did not audit SmarTalk's quarterly financial statements.

6 Hirsch was not involved in this conduct.

7 Previously, the Commission issued an Order Instituting Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings and Imposing a Cease-and-Desist Order in the Matter of Glen Andrew Folck and also filed a complaint for a civil penalty against Folck.

8 A small portion of this component ($800,000) also related to SmarTalk's intention to terminate a contract with Polaroid in 1998, which was to produce holographic images on prepaid cards. The analysis of why the Polaroid contract termination fees were improper restructuring costs is similar to the analysis of the carrier contract termination costs.

9 PwC was named as a defendant in the class action shareholder lawsuit on September 21, 1998.

10 In response to the staff's request for documents, PwC voluntarily produced documents in February 1999, that included listings of computer files showing that certain working paper files had been accessed in early August 1998. However, PwC did not tell the staff until November 1999, that some working papers and other documents relating to PwC's audit report had been revised, created and discarded.

http://www.sec.gov/litigation/admin/34-47900.htm

Modified: 05/22/2003