

PCAOB's 2019 Enforcement Actions Hint At 2020 Focus

By Robert Cox (January 17, 2020)

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After a substantial drop in disciplinary orders made public by the Public Company Accounting Oversight Board in 2018, the PCAOB experienced a modest increase in enforcement actions in 2019.

Last year, the PCAOB made 30 settled orders^[1] public, compared with 20 settled orders public in 2018, a five-year low. While 30 settled orders are approximately half of the high-water marks of 54 settled orders in 2017 and 54 settled orders in 2016, they still represent a modest increase in PCAOB enforcement activity over 2018.

Non-U.S. firms remain a focus of enforcement. In addition, violations of PCAOB auditing standards and violations related to engagement quality reviews accounted for most violations charged in orders.

In its 2019 to 2023 strategic plan, the board states that the PCAOB:

“has placed a renewed emphasis on investigating significant audit failures and have issued settled orders in numerous significant matters, covering violations related to substantive audit violations, auditor independence, document alteration, and non-cooperation.”

Despite numerous prior PCAOB orders sanctioning firms for improper workpaper creation and backdating, five of the orders sanctioned firms and accountants for failures to cooperate with a board inspection in violation of PCAOB Rule 4006, violations of PCAOB audit documentation standards, and violations of PCAOB quality control standards.

Auditor independence was a PCAOB enforcement priority in 2019, as it has been for the U.S. Securities and Exchange Commission.

Highlights

Sanctions

27 individuals and 19 firms were sanctioned. Four firms' registrations were revoked; 23 auditors were barred or suspended; 14 auditors were required to attend continuing professional education courses; and 6 auditors were restricted from acting in certain capacities (e.g., engagement partner, engagement quality reviewer, or in a quality control role).

U.S. Auditors

Over half of the 30 orders (17) involved U.S. auditors.

Global Network Firms

13 of the orders involved the six largest global network firms: Deloitte Touche, Ernst & Young LLP, KPMG International, PricewaterhouseCoopers International Ltd., BDO AG and Grant Thornton International Ltd.). 17 of the orders involved smaller accounting firms.

Non-U.S. Firms

13 of the 30 orders involved non-U.S. accounting firms or accountants. Hong Kong and Korea accounted for three orders each. Mexico accounted for two orders. Countries with one order included Bermuda, Canada, Colombia and India.

Nature of Violations

While many of the settled orders involved violations of PCAOB auditing standards, several orders involved violations of PCAOB quality control standards and independence.

For example, the PCAOB sanctioned a Mexican member firm of a global network firm for failing to comply with PCAOB quality control standards by failing to suitably design, effectively apply, and appropriately monitor quality control policies and procedures to provide reasonable assurance with respect to independence. The sanctions imposed included a \$100,000 civil money penalty.

Improper Backdating and Alteration of Workpapers Remains a Problem

Improper alteration and backdating of workpapers continues to be a problem, particularly for foreign affiliates of global network firms. Over the last five years, the PCAOB has issued several settled orders containing substantial civil money penalties against non-U.S. affiliates of the global network firms.

In 2019, two of the three largest penalties were for improper alteration by BDO Mexico and Deloitte Korea. Both firms self-reported and were given credit under the board's extraordinary cooperation policy.

Broker-Dealer Independence and Engagement Quality Review Violations Decline

In 2019, there was a significant decrease in sanctions imposed against auditors of broker-dealers for preparation of a client's financial statements or failure to obtain engagement quality reviews.

Undertakings

Like the SEC, the PCAOB is increasingly requiring undertakings by firms in its enforcement orders.

New Enforcement Director

On Dec. 17, 2019, the PCAOB announced that in January 2020, Patrick Bryan will become only the second director of the Division of Enforcement and Investigations since the PCAOB's founding.^[2]

Form 3, Special Reporting Form, Violations

PCAOB Rule 2203 requires firms to file special reports with the PCAOB upon the occurrence of such events as a firm becoming aware of a partner or audit manager has become a defendant in a criminal proceeding or disciplinary proceeding or becoming aware that such a proceeding has concluded.

Since November 2015, the PCAOB has issued multiple orders sanctioning firms for failure to timely disclose certain reportable events on Form 3. The PCAOB issued three orders involving Rule 2203 violations in 2019.

Nonidentification of Issuers and Broker-Dealers in Orders

For the first time, and consistent with new 2019 guidelines, the PCAOB is moving away from identifying issuers and broker-dealers by name in settled orders.^[3] In matters that do not involve alleged deficiencies in the performance of an audit, Division of Enforcement and Investigations staff generally recommend that the settled order not identify the issuer or broker-dealer. Staff will generally recommend identification of any issuers or broker-dealers where:

- The issuer or broker-dealer has disclosed or admitted previously to concerns regarding the financial statements or internal controls;
- A separate regulator (e.g., the SEC) has taken, or plans to take, public action against the issuer or broker-dealer or its directors or officers; or
- The issuer or broker-dealer or its directors and/or officers have been found in a public proceeding to have engaged in relevant misconduct.

Significant Settled Orders

Improper Work Paper Alteration

Two of the three highest civil money penalties sanctioned global network firm foreign affiliates for violations of PCAOB standards regarding audit documentation and improper alteration of work papers.

BDO Mexico

In October 2019, the PCAOB sanctioned BDO Mexico and six partners for participating in, directing, or contributing to the improper alteration of audit documentation.^[4] Four of the partners were found to have provided misleading information to PCAOB inspectors during the 2017 firm inspection.

BDO Mexico represents the highest civil money penalty imposed in 2019. The board imposed a civil money penalty of \$500,000 on BDO Mexico, \$10,000 on two partners, and \$5,000 on two partners. In addition, the board barred one partner for three years, two partners for two years, and one partner for one year.

The board also required BDO Mexico to undertake certain remedial actions, including establishing new policies and procedures and providing additional training to auditors.

The order states that the firm was given extraordinary cooperation credit under the PCAOB policy.

The firm's cooperation included conducting an internal investigation and sharing the factual results with Division of Enforcement and Investigations staff.

Deloitte Korea

Also in October, the PCAOB sanctioned Deloitte Korea and two former partners for violations of PCAOB quality control standards and the PCAOB Rule 4006 for failure to cooperate with a board inspection.^[5]

The firm and the partners backdated audit work papers and altered hardcopy work papers after anticipating the firm's largest issuer audit would be selected for PCAOB inspection in 2014. The board imposed a \$350,000 civil money penalty on the firm and require the firm to undertake remedial measures.

The board considered the firm's extraordinary cooperation, including that it undertook and shared the results of an internal investigation. In addition, the board imposed a civil money penalty of \$10,000 and a two-year bar on both partners.

Independence Violations

Marcum and Alfonse Gregory Giugliano, CPA

In September, the board sanctioned Marcum LLP and a former partner who was Marcum's assurance services leader and the partner in charge of compliance with auditor independence requirements for violations of PCAOB Rule 3520, auditor independence, and AU Section 220, independence.^[6]

The firm and the partner failed to comply with applicable independence requirements in connection with audits and interim reviews of 62 issuer clients that presented at the firm's annual Marcum MicroCap Conference from 2012 through 2015. The conference was an investor conference at which smaller or emerging public companies made business presentations to audiences that included potential investors.

Marcum and two senior partners made public statements advocating the high-quality investment potential of the companies presenting at the annual conference, 62 of which were the firm's issuer audit clients.

The board imposed a civil money penalty of \$450,000 on Marcum and \$25,000 on Giugliano and required Marcum to engage an independent consultant to review and make recommendations concerning Marcum's policies, procedures, staffing and training with respect to auditor independence.

Marcum Bernstein & Pinchuk

In similar factual circumstances to the Marcum order, the board sanctioned Marcum Bernstein & Pinchuk LLP, a New York firm in which Marcum held a 50% interest, for violations of PCAOB independence and quality control standards and rules.^[7]

MarcumBP's independence violations resulted from the firm's hosting of a China Best Ideas Investment Conference in 2013 and 2014. The conference was an investor conference focused on presenting Chinese public companies to audiences that included potential investors. Seven MarcumBP audit clients made presentations and/or were available for one-on-one meetings at the conferences.

The board imposed a civil money penalty of \$50,000 and required MarcumBP to undertake a review of its policies, procedures, staffing and training with respect to auditor independence.

PricewaterhouseCoopers

The PCAOB sanctioned a PwC Mexican affiliate for violation of independence standards and rules, failure to comply with PCAOB Rule 3526, communication with audit committees concerning independence, and PCAOB quality control standards.

During the 2016 and 2017 audits of the financials of an audit client that was a bank, covered persons in the firm had personal financial relationships with the client that were inconsistent with SEC regulations and PCAOB Rule 3520. In addition, the firm failed to timely make required written communications to the audit committee of the client bank that the firm covered persons had financial relationships with the client.

The board imposed a civil money penalty of \$100,000 on the firm and required the firm to undertake certain remedial measures.

Other Violations

Trainor

PCAOB sanctioned an EY engagement partner who improperly determined in the face of contrary audit evidence that an issuer's deficiencies in internal control over financial reporting were mitigated by other controls.^[8] This was the board's first order concerning a large firm engagement partner's improper evaluation of internal control over financial reporting.

The board barred Trainor from being an associated person of a registered public accounting firm for one year, imposed a civil money penalty of \$25,000, required forty hours of CPE, and if Trainor obtains consent from the board to associate with a firm after his one year bar, restricting Trainor for two years from the date of the order for roles he may perform on audits.

Kosiek

A Baker Tilly partner received a two-year bar and \$25,000 civil money penalty for violating PCAOB auditing standards in connection with the integrated audit of a mortgage originator and bank in Michigan.^[9]

Kosiek was an engagement partner. He violated PCAOB auditing standards by failing to follow-up appropriately after learning that a banking regulator had raised concerns about the client's allowance for loan and lease losses.

In addition, he failed to obtain sufficient audit evidence that the client had designed its controls to address the valuation assertion for the allowance for loan and lease losses. He also did not sufficiently evaluate the methodology used by the client to arrive at the allowance for loan and lease losses.

Other Developments

SEC Overturns PCAOB Reinhart Decision

On May 29, 2019, the SEC cancelled the disciplinary sanctions imposed by the PCAOB on a former partner of KPMG and former managing partner of KPMG's Albuquerque office, Cynthia C. Reinhart.^[10]

The SEC held that the record did not support the PCAOB's finding that Reinhart engaged in repeated instances of negligent conduct as required by Section 105(c)(5) of the Sarbanes-Oxley Act of 2002 to support the sanctions imposed by the PCAOB.

The PCAOB found that Reinhart had engaged in repeated instances of negligent conduct in the fiscal year 2007 audit of Thornburg Mortgage Inc. because Reinhart's auditing failures concerned two audit areas related to: (1) Thornburg's ability to continue as a going concern, and (2) whether Thornburg had the intent and ability to retain its investments for a period of time sufficient to allow for any anticipated recovery in market value.

The SEC found that the PCAOB had not established that the fact that two audit areas were affected by Reinhart's allegedly negligent conduct necessarily means that repeated instances of negligent conduct occurred. The SEC also held that each of the acts alleged was not negligent. The SEC rarely overturns the PCAOB Going forward, this decision creates some uncertainty about the type of conduct that constitutes repeated acts of negligence in an audit failure case.

PCAOB Hearing Officer Appointed by SEC to Address Lucia

To address its potential Lucia problem, the PCAOB's sole hearing officer, Marc B. Dorfman, was appointed by the SEC commissioners and sworn in at the SEC on April 8, 2019.^[11]

Conclusion

In 2020, I would expect the PCAOB enforcement efforts will continue to focus on non-U.S. firms, based on a belief that non-U.S. firms' system of quality control and competence of their auditors is not at the same level as the U.S. based firms.

Based on statements by board members and the issuance of a quality control concept release in December 2019, I also expect that Division of Enforcement and Investigations will be looking for potential violations of quality control standards.

Unfortunately, improper backdating and alteration of workpapers continue to be a problem area, particularly for non-U.S. firms. It also appears that there will be a new focus on independence violations.

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Notes

- [1] *The PCAOB also made public an order terminating the bar of a CPA. In 2016, Joseph M. Krusick, CPA, received a two-year bar as a sanction in a settled order. Krusick petitioned the board for a termination of the bar following two years from the date of the order, and the board granted the petition. In re Joseph M. Krusick, CPA, PCAOB Rel. No. 105-2019-011. No litigated disciplinary orders were made public in 2019.*
- [2] *Until joining the Division of Enforcement and Investigations, Bryan was the Assistant General Counsel for Enforcement at the Board of Governors of the Federal Reserve System. Bryan also served as a Supervisory Assistant Chief Litigation Counsel at the U.S. Securities and Exchange Commission's Division of Enforcement.*
- [3] *See PCAOB Staff Considerations on Recommending the Identification of Issuers and/or Broker-Dealers in Settled Enforcement Orders, <https://pcaobus.org/Enforcement/Pages/staff-considerations-recommendingidentification-issuers-broker-dealers-settled-enforcement-orders.aspx>.*
- [4] *In re Castillo Miranda y Compañía, S.C., et al., PCAOB Rel. No. 105-2019-028 (Oct. 31, 2019).*
- [5] *In re Deloitte Anjin, LLC, PCAOB Rel. No. 105-2019-025 (Oct. 31, 2019); In re Hyun Seung Lee, PCAOB Rel. No. 105-2019-027 (Oct. 31, 2019); In re Seul Hyang Wee, PCAOB Rel. No. 105-2019-026 (Oct. 31, 2019).*
- [6] *In re Marcum LLP and Alfonso Gregory Giugliano, CPA, PCAOB Rel. No. 105-2019-022 (Sep. 10, 2019).*
- [7] *In re Marcum Bernstein & Pinchuk LLP, PCAOB Rel. No. 105-2019-023 (Sep. 10, 2019).*
- [8] *In re William Trainor, CPA, PCAOB Rel. No. 105-2019-012 (June 4, 2019).*
- [9] *In re Timothy M. Kosiek, PCAOB Rel. No. 105-2019-010 (Apr. 26, 2019).*
- [10] *In re Cynthia C. Reinhart, CPA, SEC 1934 Act Release No. 85964 (May 29, 2019), <https://www.sec.gov/litigation/opinions/2019/34-85964.pdf>.*
- [11] *In Lucia v. SEC, 585 U.S. ___, 138 S. Ct. 2044 (2018), the Supreme Court held that U.S. Securities and Exchange Commission Administrative Law Judges ("ALJs") were inferior officers of the United States subject to the Constitution's appointment clause who must be appointed by the President or a delegated officer. ALJs had previously been hired as employees of the SEC. Going forward, ALJs now must be appointed by the commissioners.*

ABOUT US

Briglia Hundley was founded in 1993 and practices throughout the mid-Atlantic region. Our practice features attorneys who have been listed as "Legal Elite" by Virginia Business magazine, named to Super Lawyers, and listed in Best Lawyers.

We are a forward-thinking law firm that relies upon our experienced and energetic attorneys to reliably and responsibly meet the legal needs of our clients in Virginia, Maryland, and the District of Columbia.

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