PCAOB Enforcement Scorecard Informs On Future Priorities

By Robert Cox, Kimberly Kolar and Steve Richards (February 5, 2021)

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COVID-19 challenges appear to be a principal reason for a 30% decrease in the number of Public Company Accounting Oversight Board Division of Enforcement and Investigations settled orders in 2020 from 2019. However, PCAOB enforcement priorities were unchanged in 2020.

Those enforcement priorities are significant audit violations, cross-border audits, foreign auditors, engagement quality reviews and compliance with PCAOB rules, such as noncooperation with board inspectors and Form 3 special reporting. In addition, the PCAOB is increasing its focus on firms' systems of quality control both in inspections and enforcement.

Some key takeaways from the 2020 settled orders are:

- Continued expansion of sanctions of engagement quality reviews;
- Continued focus on cross-border audits and non-U.S. firms; and
- Increase in sanctions for firms that failed to timely file Form 3.

In addition, with the change in administrations and possible changes in leadership at the U.S. Securities and Exchange Commission and PCAOB, we expect more robust PCAOB enforcement efforts.

COVID-19 Challenges

Like many regulatory authorities, the PCAOB experienced challenges related to COVID-19 for its operations. While working from home was part of the PCAOB's vocabulary prior to the pandemic, COVID-19 forced the board to fully embrace this style of work in ways that were not previously anticipated.

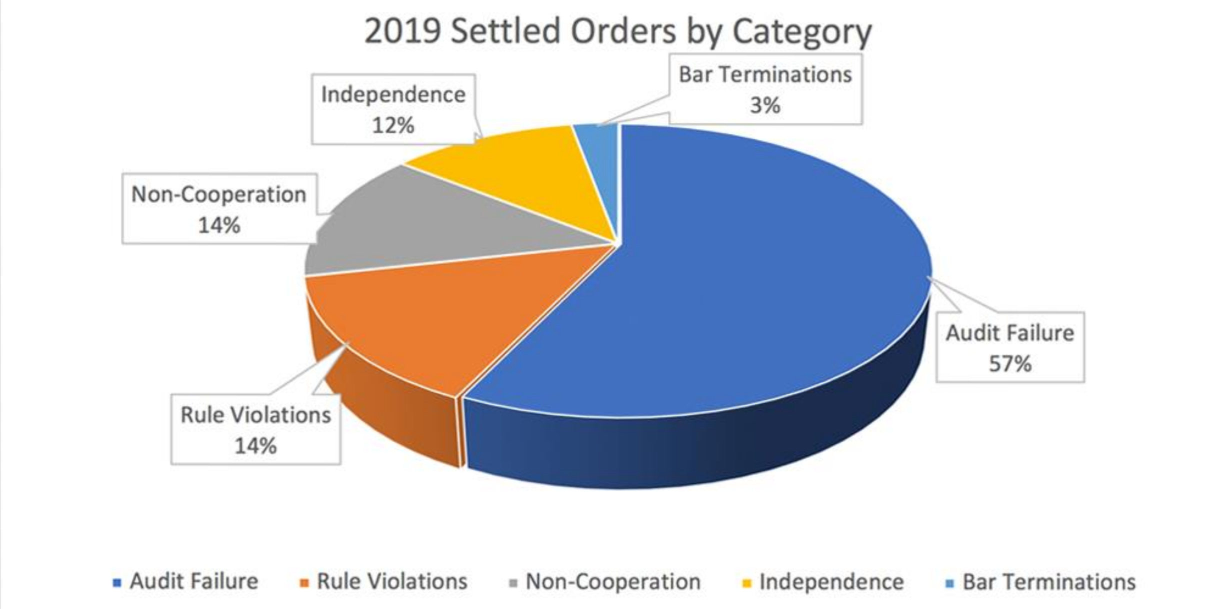
For example, in-person testimony of witnesses ceased by March. This necessitated that the board quickly evaluate its options for conducting remote testimony. Moving to a remote platform presented logistical challenges both in terms of technology and the use of exhibits. Like the SEC Division of Enforcement, the DEI staff adjusted its approach, and by late spring, the board had succeeded in resuming testimony of witnesses in investigations.

Last year was a year of personnel transition for the DEI. In January 2020, Patrick Bryan joined the PCAOB as its director — only the second to hold the position since its creation in April 2003. Then, in March, Mark Adler, the former DEI acting director and the division's chief trial counsel, departed the PCAOB.

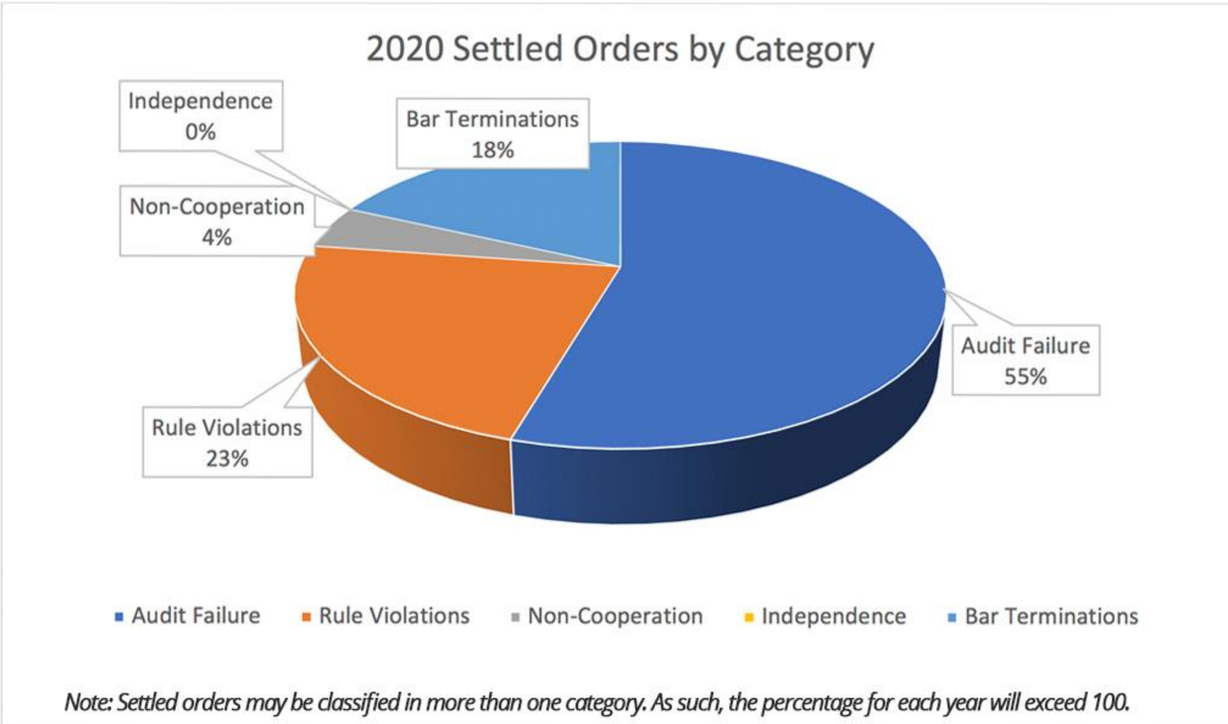
By the Numbers

The challenges present in 2020 are partially reflected in a greater than 30% decrease in the number of settled orders in 2020 from 2019. In 2020, the PCAOB made 21 settled orders public, compared with 31 settled orders in 2019.[1] This was the fewest number of settled orders made public by the PCAOB since 2013, when 13 settled orders were issued.

The chart below illustrates the categories of settled orders in 2019 and 2020 on a percentage basis. For simplicity's sake, we have used the following categories: audit failures, rules violations, noncooperation, independence and terminations of bars.



Note: Settled orders may be classified in more than one category. As such, the percentage for each year will exceed 100.



Most professionals who regularly practice in the securities regulation and enforcement space are familiar — at least on a high level — with how regulators source their cases.

For example, the SEC's Division of Enforcement routinely receives referrals from its other divisions, as well as from whistleblowers and other regulators. The PCAOB is no different. Given the SEC's own challenges related to COVID-19, there may have been fewer referrals to the PCAOB in 2020, as well as fewer referrals between PCAOB divisions, resulting in a lower number of potential matters.

Further, as part of its transformation process, the PCAOB Division of Registrations and Inspections undertook the arduous process of revamping its public inspection reports. In doing so, it created a significant backlog of reports remaining to be issued. Said differently, there are audit firms that were inspected by the DRI who have not yet received an inspection report from the PCAOB.

In fact, from 2017 to 2020, the number of issued inspection reports has decreased year over year by 19%, 32% and 84%, respectively. The significant drop of 84% from 2019 to 2020 was likely expected by the board as it appears the DRI chose to focus its initial efforts on transforming the large firm reports before turning its attention back to the smaller firm reports.[2]

The decrease in issued inspection reports may be resulting in fewer referrals to the DEI. When added to the challenges of COVID-19 and the change in leadership, these are the most likely drivers for the observed reduction in settled cases.

That said, the types of matters brought by the PCAOB remain familiar. Many of the 21 orders involved long-standing enforcement priorities, including significant audit violations, cross-border audits, foreign auditors, engagement quality reviews and compliance with PCAOB rules such as noncooperation with board inspectors and Form 3 special reporting.

However, upon reviewing the audit failure cases more closely we feel there are a few key takeaways worth mentioning.

Objectivity and Engagement Quality Reviews

The first key point is that the board continues to expand its sanctioning of engagement quality reviewers. Initially, the board issued sanctions in instances where an engagement quality review is not performed.

More recently, sanctions have included situations where the engagement quality reviewer failed to use due professional care when conducting their review, particularly while reviewing the engagement team's significant judgments. In the board's judgment, these deficiencies resulted in alleged audit failures.

In 2019 and 2020, the board also sanctioned engagement quality reviewers for a failure to maintain objectivity.[3]

Cross-Border Audits and Non-U.S. Firms

Another key point relates to the PCAOB's continued focus on cross-border audits and non-U.S. firms. Four of the settled orders involved cross-border audits and five of the orders involved foreign firms: four from China — one of which was in Hong Kong — and one from Australia.

Interestingly, challenges surrounding the auditing of related party transactions were frequently cited in the 2020 matters involving cross-border audits. In fact, five settled matters involved the failure to sufficiently audit related party transactions, four of which involved cross-border audit engagements.

Monitoring and the Integrity of Regulatory Oversight

Also noteworthy was the increase in sanctions of firms that failed to timely file Form 3 in accordance with PCAOB Rule 2203. This rule requires firms to file special reports with the PCAOB upon the occurrence of certain events, such as a firm becoming aware of a partner or audit manager becoming a defendant in a criminal proceeding or disciplinary proceeding, or that such a proceeding has concluded.

Since November 2015, the PCAOB has issued 22 settled orders sanctioning firms for failure to disclose certain reportable events on Form 3 in a timely manner. In 2020, the PCAOB issued five orders involving Rule 2203 violations, including three orders against firms from China and one from Hong Kong.[4]

The board's continued focus on Form 3 compliance demonstrates that to ensure compliance with the board's reporting requirements, there has been an emphasis on improving cooperation among U.S. regulators — primarily the SEC, the Financial Industry Regulatory Authority, the Commodity Futures Trading Commission and state accounting boards — and European regulators, an undertaking that appears to be yielding results.

Consistent with its past practice, in In re: Ryan J. Collins, the board also issued an order sanctioning a CPA for failing to cooperate with a board inspection by making a misleading statement to board inspectors and preparing a misleading document that was presented to board inspectors.[5]

With all of that said, the year 2020 lies firmly in the rearview mirror. So, what lies ahead? While nothing in life is certain, we offer the following points for consideration as we move through 2021.

Changing of the Guard Likely to Lead to More Vigorous PCAOB Enforcement Program in 2021

The incoming Biden administration has signaled that it will step up enforcement activity and federal government hiring, including at regulatory agencies such as the Consumer Financial Protection Bureau, CFTC and SEC.

In fact, Biden recently announced that he will select Gary Gensler, former head of the CFTC, to chair the SEC. During his tenure at CFTC, Gensler was known to be pro-enforcement and an aggressive regulator. He will likely bring that same approach to the SEC and pursue a wide range of enforcement cases.

The PCAOB is subject to SEC oversight and its five-member board is appointed by the SEC commissioners. With the recent announcement that board member J. Robert Brown Jr. would depart the PCAOB, the SEC has a board vacancy to fill in 2021.

Given the significant changes in the board made by former SEC Chairman Jay Clayton in 2017, the SEC may look to replace other board members, including its chairperson. If a change in the board composition does occur, any new appointee will likely be supportive of an active enforcement program, especially in light of recent accounting scandals: Wirecard AG, Luckin Coffee Inc., Danske Bank, Carillion PLC, BHS Ltd. and others.

This is in conjunction with the continued spotlight on Chinese companies listed on U.S. public markets, but that are currently unable to be inspected by the PCAOB. Given the current spotlight on auditors across the globe, the PCAOB and SEC will likely increase the zeal in which they perform their collective investor protection roles.

The DEI will certainly continue its focus on significant audit failure cases, cross-border audits and audit integrity — alteration and backdating of work papers — all of which have been a focus for more than five years.

Quality Control Finally in Focus

A firm's system of quality control plays a critical role in compliance with professional standards. For this reason, the board has focused on quality control in both the DRI and DEI, as well as in their standard-setting activities.

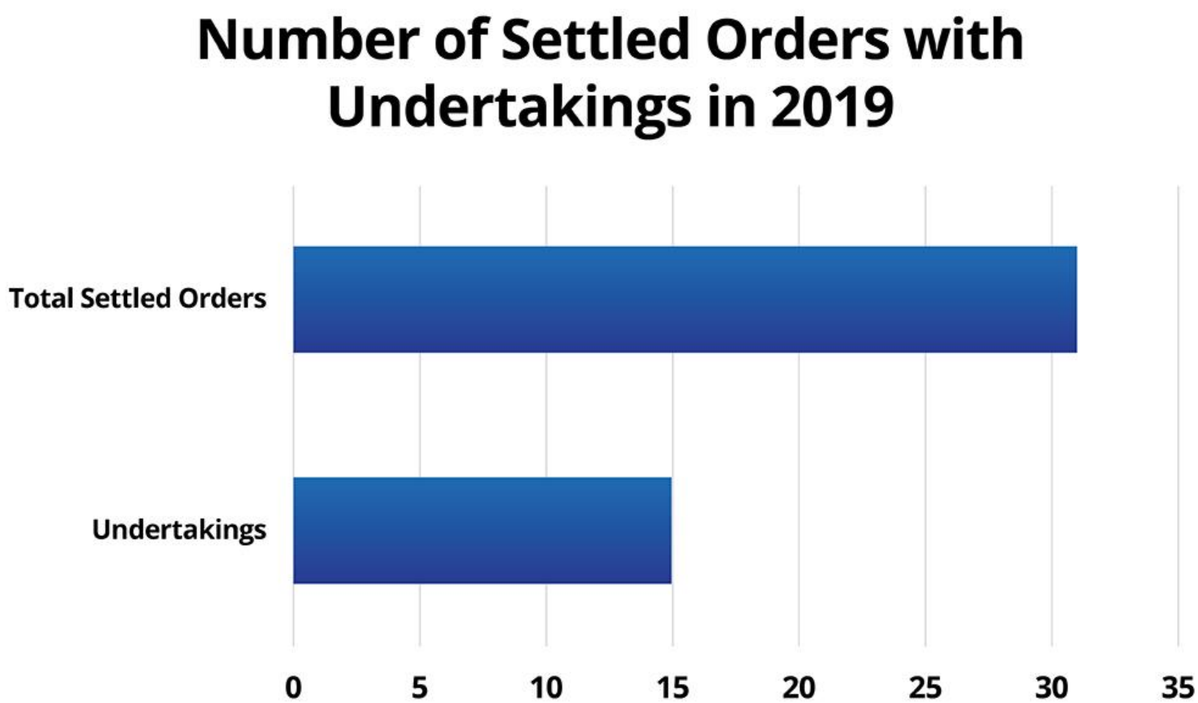
In December 2019, the PCAOB issued a concept release focusing on potential improvements to the quality control standards.[6] The concept release was informed by, among other things, the board's oversight activities. The board's quality control concept release was issued on the same day that the International Auditing and Assurance Standards Board adopted three new quality management standards (i.e., quality control standards).[7]

Given this recent flurry of activity related to quality control, it certainly appears that focusing on ways to improve the quality control standards will remain on the PCAOB's radar in 2021 and beyond. From an enforcement perspective, this likely means additional scrutiny being placed on the PCAOB staff when potential audit failures are identified without corresponding quality control findings.

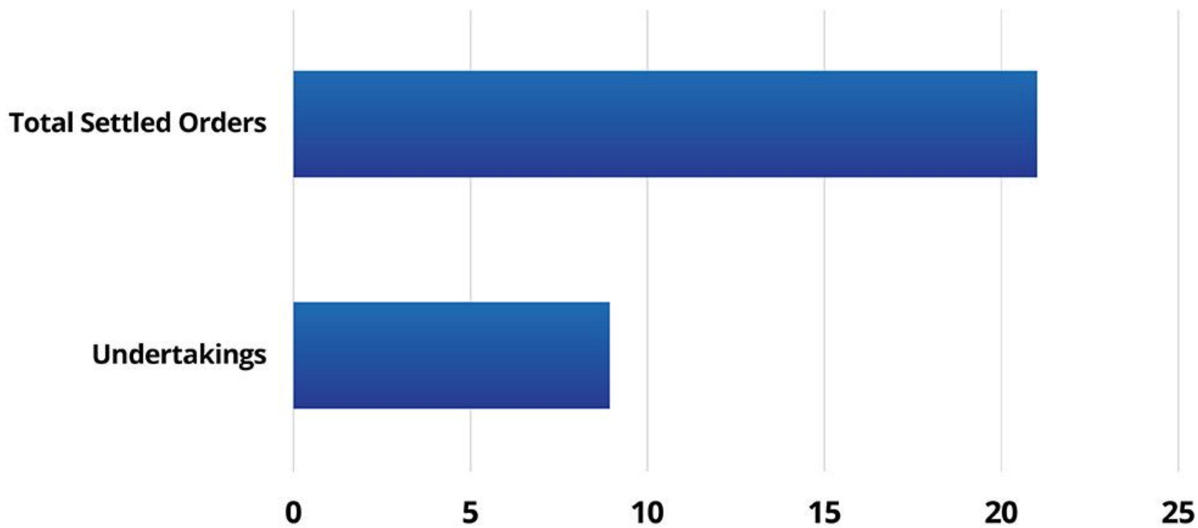
Sanction Structure

Typically, the board uses a combination of censures, bars and monetary penalties as sanctions in its matters. However, the board also employs the use of suspensions and limitations depending on the nature of the matter.

In more recent years, however, the board seems to have an interest in flexing its sanctioning muscle by incorporating remedial measures including undertakings and use of independent consultants by firms.[8]



Number of Settled Orders with Undertakings in 2020



Given the expected uptick in enforcement activity in the coming year, it seems likely these additional measures will continue to be tools in the PCAOB's enforcement toolbox.

Conclusion

Overall, in 2021, we expect more robust PCAOB enforcement efforts. The DEI will continue to focus on significant audit failures, quality control, audit integrity and compliance. In addition, the DEI will continue to apply heightened scrutiny to non-U.S. firms, based on a belief that non-U.S. firms' systems of quality control and competence of their auditors are not at the same level as the U.S. firms.

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[1] No adjudicated orders were made public in 2019 or 2020.

[2] In this context, the phrase 'large firms' refers to audit firms with 100 or more issuer audits in a given year. In a similar notation, the phrase 'small firms' refers to audit firms with less than 100 issuer audits in a given year.

[3] See PCAOB Release No. 105-2020-014 dated September 24, 2020.

[4] In re Ahmed & Associates CPA, P.C. et al., PCAOB Rel. No. 105-2020-004; In re Da Hua CPAs (Special General Partnership), PCAOB Rel. No. 105-2020-015; In re East Asia Sentinel Limited, PCAOB Rel. No. 105-2020-016; In re Ruihua Certified Public Accountants, PCAOB Rel. No. 105-2020-017; In re Zhonghua Certified Public Accountants LLP, PCAOB Rel. No. 105-2020-018.

[5] In re Ryan J. Collins, CPA, PCAOB Rel. No. 105-2020-009 (July 21, 2020).

[6] See Concept Release: Potential Approach to Revisions to PCAOB Quality Control Standards (PCAOB Release No. 2019-003 dated December 17, 2019) at https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket046/2019-003-quality-control-concept-release.pdf?sfvrsn=5856398d_0.

[7] As described above, IAASB issued the following three standards: IAS 220 (Revised), Quality Management for an Audit of Financial Statements; International Standard on Quality Management 1 (Previously international Standard on Quality Control 1), Quality Management for Firms that Perform audits or Reviews of Financial Statements, or Other Assurance or Related Services; and International Standard on Quality management 2, Engagement Quality Reviews. Each standard can be found at the respective link: https://www.ifac.org/system/files/publications/files/IAASB-International-Standard-Auditing-220-Revised.pdf; https://www.ifac.org/system/files/publications/files/IAASB-Quality-Management-ISQM-1-Quality-Management-for-Firms.pdf; and https://www.ifac.org/system/files/publications/files/IAASB-Quality-Management-ISQM-2-Engagement-Quality-Reviews.pdf.

[8] As depicted in the chart, the percentage of settled orders in 2019 and 2020 is 50% and 53%, respectively. The orders include both firm and individual undertakings, including the required use of an independent consultant, and CPE requirements.