

Responding To A PCAOB Investigation

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Lawline

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Bob Cox is a trial attorney with over two decades of experience litigating all types of business cases in courts across the nation. As part of his commercial litigation practice, Bob represents accounting firms and accountants in connection with regulatory and enforcement matters before the Securities and Exchange Commission, PCAOB, and state licensing bodies. Before joining Briglia Hundley in 2017, Bob was an Assistant Director with the PCAOB's Division of Enforcement and Investigations for more than six years.



Objectives

- Overview of Public Company Accounting Oversight Board (PCAOB)
- Overview of PCAOB Enforcement Process
- PCAOB Enforcement Priorities
- PCAOB Informal Inquiries
- PCAOB Formal Investigations
- PCAOB Disciplinary Proceedings

Basics

- Nonprofit corporation established by Congress (Sarbanes-Oxley Act of 2002)
- Oversees the audits of public companies and broker-dealers
- No accounting firm may prepare or issue an audit report for a public company or an SEC-registered broker-dealer without being registered with the PCAOB
 - Previously the profession was self-regulated
- Mission is to protect the interests of investors and public interest in the preparation of informative, accurate, and independent audit reports

Organization

- Chair and Five Board Members Appointed by the SEC
- Two of the Five Members are CPAs
- Staggered Five Year Terms
- Headquartered In Washington, D.C.
- 800+ Personnel in Offices Throughout the U.S.

Registration

- More than 2,000 firms registered with the PCAOB
- More than 1,100 domestic firms
- More than 900 non-U.S. firms located in 89 jurisdictions

Division of Registration and Inspections (DRI)

- Largest Division (60% of personnel)
- In 2016, PCAOB examined more than 780 public company audits performed by 198 accounting firms.
 - Firms that issue reports for more than 100 issuers are inspected annually
 - Firms that issuer reports for 100 or fewer issuers are inspected once every three years
- Under an interim inspection program, PCAOB examined portions of 115 audits of brokers and dealers performed by 75 firms
- Inspections designed to identify and address weaknesses and deficiencies related to how the firm conducts audits
- During inspections, the firm has a duty to allow the PCAOB access to its work papers and related documents, to provide information in writing, and make auditors available for interviews.
- For auditors of public companies, PCAOB prepares a report on each inspection of a firm and makes portions of each report publicly available

Division of Enforcement and Investigations (DEI)

- 60+ lawyers and accountants (60%/40% split) based in Washington and New York
- Authority over all registered firms, including non-U.S. firms and foreign affiliates of Global Network Firms
 - SEC does not have subpoena authority outside of U.S.
 - PCAOB can request documents from foreign firms and testimony of associated persons
 - Firm refusal to cooperate can result in registration revocation and fines
 - China continues to be an issue. PCAOB cannot conduct inspections in China. China firms frequently refuse to produce documents or make witnesses available for testimony. PCAOB has revoked registrations of several firms based on non-cooperation
- Concurrent enforcement authority with SEC
- In larger matters, SEC and PCAOB will often have parallel investigations
 - Typically, PCAOB takes the lead in investigating the auditor
 - SEC takes the lead in investigating the company

2017 Enforcement

- 55 settled and adjudicated orders made public in 2017, a slight decrease from the 59 disciplinary proceedings made public in 2016.
 - Year-to-date 2018 (10/16/2018) – 18 settled orders.
- Sanctioned firms include U.S. members of GNFs, such as PwC and Grant Thornton and non-U.S. members of the GNFs.
 - \$1.5 million civil money penalty against GT for violating PCAOB quality control standards and failing to comply with PCAOB standards in audit of The Bancorp Inc.
 - \$1 million civil money penalty against GT Indonesian affiliate for audit failure, noncooperation in connection with improper work paper alteration, and violations of quality control standards in connection with audit of Indonesian telecom
 - \$750K civil money penalty against Deloitte Turkey for improper work paper alteration

Four Higher-Priority Enforcement Areas

- Investigations involving a lack of due care and professional skepticism
- Audit matters related to the independence and integrity of the audit
- Matters threatening or eroding the integrity of the Board's regulatory oversight processes (i.e., work paper alteration and failing to timely disclose certain reportable events); and
- Matters involving risks associated with cross-border audits.
 - 40% of audit matters involved cross-border audits

Sources of Investigations

- PCAOB Inspections (DRI)
 - Public versions of inspections reports for firms on PCAOB website
- Public Source Analysis
 - SEC filings (8-Ks, 10-Ks, restatements [10-K/As])
 - News articles
 - Industry blogs
- Referrals from SEC, FINRA, and DOJ
- Tips & Referrals (i.e., whistleblowers)

PCAOB Investigatory Process

- Confidential
- Informal Inquiry
 - Document request sent out when matter opened
 - If evidence that one or more violations have occurred, DEI staff recommends obtaining an Order of Formal Investigation (“OFI”) from the Board
- Formal Investigation
 - Accounting Board Demands (documents, testimony of witnesses)
 - Testimony
 - Charging Call/Letter
 - Statement of Position
- Disciplinary Proceeding
 - Order Instituting Proceedings (OIP)
 - Hearing before Hearing Officer

Informal Inquiry

- First time a firm will usually learn of the inquiry is through receipt of an informal request from DEI
- Request for documents and information
- External factor has prompted opening of the inquiry
 - Public Source Analysis (i.e., restatement)
 - Referral from DRI
 - Tip
 - Referral from SEC or FINRA
- At informal inquiry stage, firm and associated accountant(s)' cooperation is voluntary
 - However, failing to cooperate at the informal stage may lead DEI staff to seek an OFI
- Informal inquiry and any subsequent formal investigation are confidential

Document and Information Requests

- Usually will request audit work papers for the years under inquiry
 - Typically, request will include request for a laptop computer with work papers loaded
- Will include instructions for manner of production of Electronically Stored Information (ESI)
- Other potential requests
 - Identification of members of the engagement team for audits
 - Firm's quality control procedures
 - If Global Network Firm, communications between engagement team and national office personnel
 - Firm's training in areas of focus of the inquiry
 - Engagement Quality Review
 - Auditor rotation (engagement partner and EQR)
 - Independence (i.e., preparation of financials, non-audit services, hospitality, etc.)
- Can include requests for narrative responses on certain issues (i.e., civil interrogatories)
 - Narratives are an opportunity to present information and defenses that may limit the scope or end the investigation

Initial Steps After Receipt of Request

- Litigation Hold
 - Request to preserve documents
 - Sent to members of engagement team, national office personnel if consulted
 - Preserve electronically stored information (ESI) of former employees who were members of the engagement team
 - Suspend document retention/document policy as to identified custodians
 - Notify IT personnel
- Seek any necessary scope limitations on searches/request extension if necessary from DEI staff
 - Introduction to staff – opportunity to seek guidance from the staff about focus areas of inquiry
 - DEI staff will not approve scope limitations but will often provide feedback on search terms
 - Extension of longer than 2 weeks – will need to present facts supporting need for extension

Work Paper Alteration

- PCAOB Auditing Standard (“AS”) 1215, *Audit Documentation*
 - A complete and final set of audit documentation should be assembled for retention not more than 45 days after the audit report release date
 - Audit documentation must not be deleted or discarded after the documentation date
 - Documentation may be added after the documentation date, but the engagement team must identify the date it is being added, the name of the person who prepared the additional documentation, and the reason(s) for adding it (AS 1215.16)
- Do not alter work papers in advance of an inspection or prior to production to DEI staff
- Violation of PCAOB Rule 4006 regarding cooperation with a PCAOB inspection if work papers improperly altered in advance of PCAOB inspection
- Violation of PCAOB Rule 5110 if work papers are improperly altered and produced to DEI staff in response to an ABD

Work Paper Alteration (cont'd)

- Common improper alterations after the documentation date involve:
 - adding sign-offs and sign-off dates
 - adding new work papers
 - revising conclusions reached in audit steps or memoranda in the work papers
 - completing checklists

Work Paper Alteration (Enforcement)

- Focus of DEI staff in recent years
 - Audit Practice Alert No. 14, *Improper Alteration of Audit Documentation*
 - Several settled orders and litigated orders where firm and accountants charged with noncooperation due to improper work paper alteration
- To date, the PCAOB has issued 70 disciplinary orders concerning failures to cooperate with a Board inspection or investigation, and the majority have involved improper document alteration
- Record fine to date of \$8 million imposed against Deloitte's Brazilian affiliate primarily for noncooperation violations associated with improper work paper alteration

Work Paper Alteration (Enforcement Cont'd)

- In 2017, the Board announced six settled orders and an adjudicated order decided by the SEC sanctioning firms and individuals for improper alteration of work papers.
- 2017 Significant Settled Orders
 - \$1 million civil money penalty against Ernst & Young Global's Indonesian affiliate, KAP Purwantono, Sungkoro & Surja, for audit failure, noncooperation in connection with improper document alteration, and violations of quality control standards in connection with the 2011 audit of an Indonesian telecommunications company
 - \$750,000 civil money penalty against Deloitte Touche Tohmatsu Limited's affiliate in Turkey for noncooperation in connection with improper document alteration (money penalty lower as a result of extraordinary cooperation credit).

Work Paper Review

- Most large and regional firms have moved to electronic work papers
- DEI staff reviews metadata from work papers produced to inspections, work papers produced to DEI, and engagement quality reviews and looks for inconsistencies
 - DEI staff also compares hard copy work papers with the same work papers produced in electronic form
- As an initial step, counsel should review work paper metadata and look for potential issues
 - Initials and signatures that may have been added after the date
 - Checklists
 - New work papers
 - New conclusions

Privilege and Work-Product

- As with any document review, the firm and its counsel should be mindful of potentially privileged documents
- Privileged documents can be in the work papers (i.e., documents relating to restatement, contingent liabilities, etc.)
- Email communications with client's counsel
- Majority of courts have held that disclosure of attorney work product to the outside auditor does not result in a waiver of the work product protection. *See e.g., United States v. Deloitte LLP*, 610 F.3d 129, 142 (D.C. Cir. 2010).

Privilege and Work Product Claims

- PCAOB Rule 5106 addresses the assertion of privilege.
- Generally requires the firm to produce a privilege log identifying the date of the document, type of document, the author, the recipients, and the nature of the privilege.
- DEI staff will scrutinize privilege logs and challenge privilege assertions that they believe lack adequate support
- Internal investigations – firms should be careful about disclosing investigation reports and related materials that are privileged.
 - Recent court decisions have found waiver of work-product in production of materials to the SEC. *See e.g., In re Initial Pub. Offering Sec. Litig.*, 249 F.R.D. 457, 465-67 (S.D.N.Y. 2008); Order on Defs. Mot. To Compel Produc. From Non-Party Law Firm, SEC v. Mathias Francisco Sandoval Herrera, No. 17-cv-20301 (S.D. Fla. Dec. 12, 2017).

Parallel Investigations

- On occasion, the SEC or FINRA (broker-dealer) may have a parallel investigation open as to the listed company or broker-dealer)
- While PCAOB investigations are confidential, SOX allows PCAOB to share information and documents gathered in an investigation with the DOJ, SEC, FINRA, and other regulatory authorities
- Information sharing with SEC, DOJ, etc. - Need to seek Board approval to share documents and information
 - Authority to share documents with SEC routinely included in OFI

Potential Ways to Resolve An Inquiry

- Communicate with DEI staff early and produce requested documents and information as soon as practicable
- Express willingness to answer questions and address concerns from staff as the inquiry proceeds
- Offer to meet with staff by telephone or in person to lay out the firm's best case as to why no violation(s) of PCAOB rules or standards have occurred
- If the firm believes one or more violation(s) have occurred, consider proactive steps early on in the inquiry that may qualify the firm for extraordinary cooperation credit
- Alternatively, explore possibility for early resolution of the matter through a settled order

Extraordinary Cooperation Credit

- Since 2013, the PCAOB has provided credit for extraordinary cooperation in connection with investigations
- The types of cooperation that could result in credit are:
 - Voluntary and timely self-reporting
 - Voluntary and timely remedial or corrective action
 - Voluntary and timely substantial assistance to the Board's investigative processes or to other laws enforcement authorities
- If the firm believes that one or more violations have occurred, the firm may want to proactively disclose all of the facts and cooperate extensively with DEI staff to qualify for extraordinary cooperation credit that will result in lesser sanctions

Extraordinary Cooperation (Settled Orders)

- DRT Bagimsiz Denetim ve Serbest Muhasebeci Mali Musavirlik AŞ (“DT-Turkey”) – lower sanction of \$750K fine based on firm cooperation
 - Firm conducted its own internal investigation and shared the results
 - Firm and individuals provided substantial assistance and provided significant information concerning their actions in altering work papers
 - Firm began implementing remedial measures
- Baum and Company, P.A. and Joel S. Baum, CPA
 - Small firm and engagement partner received credit for disclosure of work paper alterations to PCAOB inspectors at the start of their inspection
 - Provided the inspections staff with a list identifying those work papers they remembered altering and describing the alterations in general terms

Formal Investigations

- If the DEI staff believe that one or more violations of Board rules or standards or the securities laws have been violated, the staff requests that the Board issue an OFI
- Once an OFI has been issued, the firm and/or associated persons must cooperate with the investigation
 - Firm or associated person can request a copy of the OFI from DEI
 - OFI will list potential PCAOB rules, standards, and securities laws that staff believe may have been violated
- Typically, first notice to the firm that an informal inquiry has become a formal investigation is the receipt of an Accounting Board Demand (ABD).

ABD for Documents

- The first ABD issued will likely be for documents only under Rule 5103
- Will reference and incorporate prior informal requests
 - Failure to produce all responsive documents at the formal stage can lead to potential noncooperation charge
- May include new requests for documents and narratives

ABD for Testimony

- Rule 5102 – ABD for testimony
 - Can be for individual such as engagement partner, EQR, manager, etc.
 - Can also be for firm designee on certain topics (similar to FRCP 30(b)(6) corporate designee)
- May also include document requests
 - Document requests usually the same as the requests in the initial document ABD to the firm
 - However, review carefully for witness specific requests
- Sets date for initiation of testimony and usually designates Washington, D.C. (or New York City if DEI staff in NYC are assigned to the investigation) as location
- No time limit on testimony
 - Unlike under federal civil discovery rules (FRCP 30), there is no seven hour limitation
 - Testimony may continue for multiple days
 - Witness can be called back for further testimony at a date in the future

Testimony

- Testimony led by a DEI staff attorney
- DEI staff accountant will attend testimony, ask questions and follow-up questions, and may lead portions of testimony on certain technical topics
- Court reporter present
 - On rare occasion, testimony may be videotaped
- In international/cross-border investigations, if witness located outside of U.S., on occasion, DEI staff will travel to witness's location
 - In very limited instances, DEI has conducted testimony by video conference

Testimony – Rights of Witness

- PCAOB Rule 5109
- Witness shown copy of OFI prior to start of testimony (Rule 5109(a))
- Right to counsel (Rule 5109(b))
 - *Laccetti v. SEC* – 3/23/18, D.C. Circuit held that right to counsel in a PCAOB investigation includes ability to have accounting expert present to assist counsel
- Upon written request to Director, DEI, witness may inspect the official transcript of the witness's own testimony and request a copy
 - Within Director's discretion to deny request for copy of transcript

Conclusion of Investigation

- Close investigation or issue charging letter
- Firm/accountants charged have right to submit Statement of Position
- Order Instituting Proceedings (OIP)
- Hearing Officer
 - Like a trial
 - Expert witnesses (former auditors and accounting professors)
- Appeal to Board
 - *De novo review*
- Appeal to SEC Commissioners
- Appeal to Federal appellate court

Statement of Position (SOP)

- Rule 5109(d)
- Similar to Wells submission to the SEC
- Opportunity for the firm to lay out reasons why it should not be charged or to narrow the charges
- Firm provided with the opportunity prior to DEI staff presenting a recommendation to the Board for issuance of an Order Instituting Proceedings (OIP) commencing a disciplinary proceeding
- If DEI staff decides to recommend issuance of an OIP, a copy of the SOP is provided to the Board

Disciplinary Proceeding

- Hearing may be scheduled six to twelve months after the OIP is issued
- Conducted before PCAOB's sole hearing officer
- Similar to bench trial or arbitration
- DEI and firm/accountant each have the opportunity to present their case and defenses
- DEI puts in case primarily through cross-examination of firm witnesses
- Both sides may use expert witnesses to opine on whether or not conduct is consistent/inconsistent with PCAOB standards
- After hearing, parties often provided the opportunity to submit post-hearing briefs
- After hearing and submission of briefs, hearing officer issues an initial decision

Questions

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