

15 Years Of SOX: Avoiding PCAOB Enforcement Sanctions

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Law360, New York (August 7, 2017, 11:46 AM EDT) -- July 30, 2017, marked 15 years since the Sarbanes-Oxley Act of 2002 was enacted in response to scandals at Enron, WorldCom and elsewhere, introducing strict reforms to improve corporate financial disclosures and prevent accounting fraud. Has the law been effective or too burdensome? This Expert Analysis special series examines the impact of various aspects of SOX.

For most of United States' history, those accounting professionals involved in public company auditing have had no dedicated federal regulatory oversight. While the U.S. Securities and Exchange Commission occasionally disciplined accounting firms and individual accountants in matters related to its enforcement of securities violations by public companies, state licensing authorities and professional associations such as the American Institute of CPAs (AICPA) acted as the principal regulator for accountants. This changed in 2002. Following several significant auditing disasters involving some of the most prominent accounting firms in the world, including scandals at Enron and WorldCom, Congress created the Public Company Accounting Oversight Board as part of reforms enacted under the Sarbanes-Oxley Act.

The board created two divisions focused on oversight of accounting firms and accountants involved in audits of public companies, and, more recently under the Dodd-Frank Act, audits of broker-dealers registered with the SEC. These are Division of Registration and Inspections ("Inspections") and the Division of Enforcement and Investigations ("DEI"), which is composed of both attorneys and accountants. Under PCAOB rules, Inspections annually reviews accounting firms that conduct more than 100 audits of public companies. It inspects all other firms or accountants registered with the PCAOB at least every three years. For most firms, their interaction with the PCAOB will begin and end with Inspections.

In a very few instances, accounting firms and members of their audit staff will find themselves involved in an enforcement investigation brought by the DEI. Fifteen years after its creation, critics of the PCAOB's enforcement program point to the statutory restriction under which the DEI operates, the pace of actions, and the volume of cases brought as evidence of a lack of real accounting industry oversight



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and a generally ineffective enforcement program.

For years, PCAOB leaders have sought to change what they perceive as the statutory impediment to the DEI's program that requires its hearings to be nonpublic matters. Chairman James Doty and others at the PCAOB have focused on the effect this has on DEI's program. However, without congressional action, unlikely for the next few years, the benefits to prospective targets of the way the PCAOB must conduct its enforcement proceedings will continue.

Clearly, this is good news for accounting firms and their members who might become subjects of enforcement actions. This may be less good for the reputation of members of industry as a whole, who follow the rules, give great service to clients, and yet whose profession potentially gets tarnished when the misdeeds of a few bad actors — and the length of time it took the PCAOB to sanction them — comes to light. However, over the past three years, the PCAOB has significantly increased the number of enforcement actions it has brought. Thus, even though the secrecy and delay may favor those few unlucky enough to be investigated, it is better to avoid a potential investigation. Understanding how DEI chooses its cases, investigates them and occasionally litigates, but most likely settles, them can substantially increase the likelihood of a successful outcome.

The Inspection Process: You Have a Great Opportunity to Avoid the DEI

The PCAOB has a robust inspections program. As a result, many of the investigations of accountants and firms that DEI ultimately initiates result from audit deficiencies and other issues identified during the inspections process. As established and implemented, the PCAOB inspection program is an iterative process that focuses on remediation, not enforcement. Following the inspection visit, the Inspection accountants will prepare a preliminary report of audit issues and deficiencies, labeled in the report as “comments,” that the inspectors have identified. It then sends a draft report to the accounting firm for its response and explanations. This allows the firm, preferably with the assistance of experienced counsel, to respond to or accept the various alleged deficiencies and agree to remedy them. This is a critical point at which a firm can prevent future problems, including an enforcement investigation, from happening. When the iterative process is completed, Inspections will send a report identifying deficiencies that a firm must address. The firm then has 12 months to remediate. Successful remediation under Rule 4009 generally precludes any public disclosure of criticisms or potential defects in the firm's quality control systems and potential enforcement action.

Nonpublic Hearings: An Investigation is Not the End of the World

The Sarbanes-Oxley Act and the PCAOB rules under which DEI must act create an unusual process that greatly benefits those being investigated. In contrast to standard policy for almost every other regulatory authority, Congress imposed a veil of secrecy on PCAOB enforcement matters. Sarbanes-Oxley and the board's Rule 5203 forbid disclosure of all enforcement matters unless the subjects agree to a public hearing or until the board has rendered a final decision that imposes a specific sanction. Not surprisingly, the next time a subject agrees to such a public hearing will be the first time. Here, unlike most regulatory proceedings, the concept of a “presumption of innocence” has real meaning, such that an individual or firm's reputation cannot be tainted by unproven allegations, as it may be by an SEC civil complaint or a U.S. Department of Justice criminal indictment.

The Process: Take the Long and Winding Road

The secrecy of the investigation process encourages a respondent and their lawyer to draw out any

investigation or subsequent litigation of any disciplinary proceeding authorized by the board and prosecuted by DEI before the PCAOB hearing officer. The results are predictable. In many cases, a final decision, if ultimately rendered with specific sanctions, occurs many years after the violation. Illustrative is In the Matter of Randall A. Stone, CPA, a proceeding involving an auditor in which the board did not impose sanctions until 2014 for conduct related to a 2007 audit. Similarly, in 2016, 32 of the 47 final orders that the board issued, all of which were consent orders, involved conduct related to audits that occurred in 2012 or earlier. Moreover, in every matter, the respondents were able to achieve a settlement, often on terms more favorable than would have been available at the start of the investigation. Further, almost every settlement is on a neither-admit-nor-deny basis so that the findings have no independent legal effect beyond the PCAOB, although state boards and the AICPA may institute their own related actions.

The Division's Enforcement Procedures

Both DEI's rules and its internal practices provide further benefits for potential respondents. Under Rule 5100, the director of DEI may initiate an "informal inquiry," i.e., a preliminary investigation, and issue an accounting board request (ABR) for the voluntary production of documents, testimony or other information. More recently, as part of the ABR process requesting other "information," DEI has asked for narrative responses to specific issues. These narrative responses, similar to a pre-Wells response in an SEC matter, provide the firm with the opportunity, ideally with the assistance of counsel, to submit detailed information and explanations that may curtail or end the investigation or, at a minimum, influence its direction. Careful attention at this stage can result in matters that are ended early that otherwise may well have resulted in an order of formal investigation. With careful attention at this stage we have been able to end matters for our clients that previously may have resulted in an order of formal investigation.

If the matter cannot be resolved at the informal stage, DEI likely will initiate a formal investigation pursuant to Rule 5100 by obtaining an order of formal investigation from the board. DEI then generally issues an accounting board demand (ABD) for testimony under Rule 5102 and an ABD for audit work papers and other documents pursuant to Rule 5103. DEI can require the testimony of any person associated with a registered public accounting firm. It also can ask the SEC to issue a subpoena for those who are not. Practitioners involved in responding to ABDs frequently find that DEI's investigative process is lengthy and comprehensive. Because the division generally does not further depose any witnesses after it commences a formal disciplinary litigation before a hearing officer, this testimony process is often lengthy. Testimony from a single accounting witness can last more than a week. While arduous, this process allows for a thorough review of any potential issues and for direct and regular interaction by the firm and its counsel with DEI lawyers and accountants. As with the informal process, effective, experienced representation will enhance opportunities for a favorable negotiated settlement.

Even if the investigation results in DEI's recommendation pursuant to Rule 5200 that the board commence a formal disciplinary proceeding before a hearing officer, DEI rarely litigates such matters to a final judgment that results in the board order imposing specific sanctions. Because, under Rule 5203, these litigated matters are not public, it is impossible to know how many cases the division has litigated. However, it is known that in its 15 years, the division has litigated only 20 such matters that resulted in board findings of violations. (If the respondent prevails at the hearing or in an appeal to the board or the SEC, the matter is never reported.) By any measurement, this is an enforcement process that a respondent can successfully navigate.

Avoiding PCAOB Enforcement

In recent years, the Division of Enforcement has brought an increasing number of cases. In 2013 it resolved only 13 cases. That number rose to 24 settled matters in 2014, 42 in 2015, 47 in 2016, and 29 through June 2017. While this indicates increased enforcement activity, many of these cases do not involve the actual audit itself. Rather, many of these recent cases involve sanctions relating to: (1) violation of PCAOB reporting rules, (2) violation of independence rules that may affect audit quality, or (3) most commonly, issues relating to the investigation itself.

A review of the matters settled in 2016 and 2017 provides insight into DEI's enforcement procedures and a road map for firms and individuals to avoid an investigation and its sanctions. Of the 29 matters brought this year, seven involve the failure of auditors to disclose reportable events on Form 3 regarding disciplinary proceedings that other regulators brought against them. Eight matters involve firms and accountants who do other work for the issuers or registered broker-dealers in violation of the SEC's independence rules for accountants conducting such audits. Finally, 30 audit firms and its members have been sanctioned for failing to cooperate with the investigation or altering or adding to the working papers produced during the investigation. These cases are examples of a well-known adage among enforcement lawyers: "it is not the crime but the coverup" that results in sanctions for clients. As DEI's director recently warned: "Improper document alternation is a black and white issue There is nothing grey when it comes to this form of misconduct." From this it is clear that registered accounting firms and its members who comply with PCAOB and SEC rules and refrain from obstructing the investigation will likely be able to avoid costly investigations by DEI and sanctions by the board.

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