

Tips For Defending PCAOB Investigations

By Robert Cox (April 18, 2018)

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The Public Company Accounting Oversight Board continues to be active in the enforcement of laws, regulations and auditing standards applicable to accounting firms and accountants performing audits of public companies and broker-dealers. It is important for auditors and their counsel to be aware of the PCAOB investigatory process and decision points in the process should they become the focus of a PCAOB informal or formal investigation. The following are some tips and considerations in representing an accounting firm and accountants in a PCAOB investigation, including some recent developments that impact how counsel defend an investigation.

The Informal Inquiry

The PCAOB's Division of Enforcement and Investigations, or DEI, opens numerous enforcement matters each year. Typically, the first step in the process is the opening of an informal inquiry. Under PCAOB Rule 5100, the director of the DEI may undertake an informal inquiry where it appears that a firm or associated person of the firm may have violated PCAOB rules or auditing standards or securities laws.^[1] At the informal inquiry stage, the DEI may request documents, information or testimony from, or an interview with, any person.^[2] The first time the firm will usually learn of the inquiry is through receipt of an informal request, also known as an accounting board request.^[3] Unless the inquiry primarily involves potential independence violations, the focus of the informal request will be on the audits of one or more issuers or broker-dealers. Therefore, the documents that will form the focus of the inquiry will be found in the archived work papers.

Key factors to keep in mind when receiving an informal request:

- An external factor has prompted the opening of the inquiry, such as a restatement, a referral of an issue identified by the PCAOB's Division of Registration and Inspections, or a referral from the U.S. Securities and Exchange Commission;^[4]
- Frequently, the PCAOB and SEC have parallel investigations and will coordinate closely during the investigation;^[5]
- At the informal inquiry stage, the firm's and associated person(s)' cooperation is voluntary;
- The informal inquiry and any subsequent formal investigation are confidential;^[6] and
- Archived work papers may not be deleted or altered.

Litigation Hold

Upon receipt of a request, the firm should immediately identify all key current employees as well as former employees who may have responsive documents. Within a short period of receiving the request, the firm or its counsel should issue a litigation hold to all persons who may have documents and information potentially responsive to the request. The firm should also notify its information technology personnel to take steps to preserve ESI, including suspending the document retention policy with regard to document custodians.

Work Paper Preservation

As part of the preservation process, the firm should be mindful of recent significant PCAOB settled disciplinary orders involving the improper alteration or backdating of audit documentation.^[7] Improper document alteration has been one of the four higher-priority enforcement areas in recent years.^[8] Under PCAOB Auditing Standard 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.^[9] Audit documentation must not be deleted or discarded after the documentation date, but information may be added.^[10]

There may be a temptation by the engagement team to alter work papers in advance of a PCAOB inspection or after receipt of a DEI request. Firm leadership, in-house counsel and outside counsel should take this into account not only at the preservation stage, but also as part of the firm's continuous training of personnel. It is a violation of PCAOB rules regarding noncooperation to not only improperly alter work papers as part of an investigation, but also in advance of a PCAOB inspection.^[11]

In reviewing work papers to be produced, counsel should review metadata, if the work papers were created electronically, to determine whether there are potentially any work paper alteration issues.

Privilege and Work-Product Claims

In conducting the search, the firm and its counsel should be mindful of potentially privileged documents. These documents can take the form of the accounting firm's own communications with its inside or outside counsel or also attorney work product of the firm's client that may be in the audit work papers or the files of the engagement partner. A 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.^[12] To the extent the firm has any of its client's protected materials in the work papers or engagement team files, the firm will need to reach out to and coordinate with its client to ensure that there is no waiver of the client's protected materials.^[13]

PCAOB Rule 5106 addresses the assertion of privilege. It generally requires the firm to produce a privilege log identifying the date of the document, type of the document, the author, the recipients, and the nature of the privilege. In certain instances, the firm may want to share privileged documents, such as an investigative report, with DEI staff. Counsel will have to weigh whether the potential benefit of narrowing the issues or

persuading the staff to close the inquiry is outweighed by the risk of waiver of work-product protection. Cases, including a December 2017 decision by a federal magistrate judge in Florida, raise the possibility that disclosure to government authorities, such as the SEC and PCAOB, may result in waiver, including subject-matter waiver.^[14] Even an oral synopsis of the contents of work-product-protected investigation reports, memoranda and interview notes may risk waiver.^[15]

Extraordinary Cooperation Credit

Since 2013, the PCAOB has provided credit for extraordinary cooperation in connection with board investigations.^[16] The types of cooperation that could result in credit are voluntary and timely self-reporting, voluntary and timely remedial or corrective action, and voluntary and timely substantial assistance to the board's investigative processes or to other law enforcement authorities.^[17]

If the firm and/or outside counsel identify 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. The firm should pursue this opportunity early on in the inquiry. Two recent PCAOB settled orders highlight the advantages of the extraordinary cooperation credit.

In a December 2017 settled order, the PCAOB gave extraordinary cooperation credit to Deloitte Turkey and two former partners who self-reported their alteration of work papers to PCAOB in 2016. In *DRT Bagimsiz Denetim ve Serbest Muhasebeci Mali Musavirlik AŞ* ("DT-Turkey"), the PCAOB sanctioned a Deloitte Turkey engagement partner and DT-Turkey's risk and reputation leader and former national professional practice director for improper alterations to archived work papers.^[18] The board imposed a civil money penalty of \$750,000 on DT-Turkey, required the firm to remediate and implement certain policies and procedures related to its system of quality control, required the firm to report certain information to board staff for two years, and required the firm to provide additional training. The board censured, suspended for one year, and limited the activities for an additional year of the engagement partner on one of the audits at issue. In the order imposing the sanctions, the board granted extraordinary cooperation credit to Deloitte Turkey and the two former Deloitte Turkey partners who settled. In the order, the board stated that absent the firm's extraordinary cooperation, the monetary penalty imposed would have been significantly

larger and the board may have imposed other, additional sanctions.^[19] In granting the extraordinary cooperation credit, the board noted:

- The firm conducted its own internal investigation and shared the results with DEI staff;
- The firm and individuals provided substantial assistance in the investigation;
- The firm began implementing remedial measures in response to the misconduct; and
- The individuals provided significant information concerning the actions of the firm and its personnel.^[20]

In a Feb. 27, 2018, settled order, Baum and Co. PA and Joel S. Baum, CPA, a small firm and its engagement partner received extraordinary cooperation credit for their disclosure of work paper alterations to PCAOB inspectors at the start of their inspection.^[21] After self-reporting to inspectors, the respondents provided the inspections staff with a list identifying those work papers that they remembered altering and described the alterations in general terms.^[22] PCAOB imposed a one-year revocation of the firm's registration, a one-year bar on the engagement partner, and a \$10,000 civil money penalty on the firm.

The Formal Investigation

If the DEI staff believe there are sufficient grounds for proceeding after conducting an informal inquiry, the DEI will seek an order of formal investigation, or OFI, from the board.^[23] Under PCAOB Rule 5109(a), any person who is compelled to testify or produce documents pursuant to an accounting board demand issued under Rules 5102 or 5103, shall, upon request, be shown the board's order of formal investigation. Rule 5109(a) also states that "[i]n the discretion of the Director of Enforcement and Investigations, a copy of the order of formal investigation may also be furnished to such a person for his or her retention, subject to such limits on dissemination as the Director may require."^[24]

At the OFI stage, the firm and associated persons are required to cooperate with a formal investigation, and failing to comply with a formal request for documents, information or testimony can lead to a charge of noncooperation with an investigation under Rule 5110. The sanctions for noncooperation can be severe.^[25]

The formal investigation is a much more burdensome and lengthy process than an informal inquiry. DEI staff can issue accounting board demands for documents and/or testimony of witnesses.^[26] Unlike under Federal Rule of Civil Procedure 30(d), which limits deposition testimony of witnesses to one day of seven hours, Rule 5102 provides no limit on duration of the testimony of witnesses. In practice, this means that DEI staff can conduct testimony over more than one day. This means that counsel should extensively prepare witnesses for testimony.

A recent development has enhanced the ability of defense counsel to defend witnesses in testimony.

Accounting Experts May Now Assist Defense Counsel in Interviews and Testimony

Due to a 1985 district court case, SEC v. Whitman, the SEC has long permitted experts to provide assistance to defense counsel in representing a witness at an SEC interview or testimony.^[27] However, until March 23, 2018, the DEI took the position that it could bar accounting experts from attending interviews and testimony under its authority under Rule 5102(c)(3). This meant that in testimony, the DEI had the benefit of expert assistance through the presence of one or more DEI staff accountants while defense counsel and the witness were denied similar assistance from their own expert. Moreover, DEI accountants are permitted under the rules and frequently do question witnesses in testimony.

On March 23, 2018, the D.C. Circuit ruled that the right to counsel in a PCAOB investigation includes the ability of having an expert present to assist counsel.^[28] In Laccetti, the DEI permitted an Ernst & Young LLP attorney to represent an EY engagement partner, Mark Laccetti, at an investigative interview, but denied Laccetti's request to be accompanied by an accounting expert from EY under PCAOB Rule 5102(c)(3). The PCAOB argued that it excluded the EY accounting expert because it did not want EY personnel to monitor the investigation. The court held that the PCAOB's reasoning "makes no sense here."^[29] An EY attorney was already planning and did attend Laccetti's interview consistent with board policy and relevant ethics rules. The PCAOB's denial of Laccetti's request was arbitrary and capricious.

In addition, the court held that the board’s rules providing the right to counsel (PCAOB Rule 5109(b)) should be read to encompass the right to have an accounting expert to be present and assist defense counsel at the interview. The court found Whitman to be persuasive and found no difference to the right to counsel under the Administrative Procedures Act and the right to counsel under the board’s rules. The court held that “[u]nder the Board’s rules, the Board therefore may not bar a witness from bringing an accounting expert who could assist the witness’s counsel during an investigative interview. (To prevent monitoring, the Board may exclude a company-affiliated accounting expert when no other company-affiliated personnel are allowed at the interview).”^[30]

The Laccetti ruling will substantially level the playing field in PCAOB investigative interviews and testimony. Firm counsel will now be able to bring an accounting expert to assist in the representation of a witness during interviews and testimony. While legal counsel representing firms may be skilled in the audit regulation area, as noted by Whitman, “counsel trained only in the law, no matter how skillful, may on occasion be less than fully equipped to serve the client in agency proceedings. Unless the lawyer can receive substantive guidance from an expert technician — in this case, an accountant — when he determines in his professional judgment that such assistance is essential, his client’s absolute right to counsel during the proceedings would become substantially qualified.”^[31]

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Notes

- [1] PCAOB Rule 5100 provides: “where it appears that, or to determine whether, an act or practice, or omission to act, by a registered public accounting firm, any associated person of that firm, or both, may violate — (1) any provision of the Act; (2) the Rules of the Board; (3) the provisions of the securities laws relating to the preparation and issuance of audit reports ...; or (4) professional standards.”
- [2] Under the Sarbanes-Oxley Act of 2002, as amended, all PCAOB informal inquiries and formal investigations are confidential.
- [3] PCAOB Rule 5100(b).
- [4] Claudius B. Modesti, Director of Enforcement, Enforcement Update, AICPA Conference on Current SEC and PCAOB Developments (Dec. 10, 2014); Chris Gaetano, FAE Speaker Offers Up-Close Look at PCAOB Process for Investigating Firms (Jun. 12, 2014).
- [5] Remarks of Peter Bresnan, Senior Advisor to the Director of DEI at “Auditor Liability 2018: Trends in SEC & PCAOB Enforcement & Developments in Private Firm Litigation,” D.C. Bar (April 10, 2018).
- [6] Under the Sarbanes-Oxley Act of 2002, as amended, all PCAOB informal inquiries and formal investigations are confidential. PCAOB Rule 5108, Confidentiality of Investigatory Records, states that any documents, testimony or other information prepared or received by the board in connection with inquiries and investigations shall be confidential unless and until presented in connection with a public proceeding or released in accordance with Section 105(c) of the act.
- [7] See e.g., *In the Matter of Deloitte Touche Tohmatsu Auditores Independentes*, PCAOB Rel. No. 105-2016-031 (Dec. 5, 2016). See also, PCAOB Staff Audit Practice Alert No. 14, *Improper Alteration of Audit Documentation* (April 21, 2016).
- [8] See Claudius B. Modesti, *Crossing Borders, Digging Deep: DEI’s Investor Protection Efforts in 2017*, AICPA Conference on Current SEC and PCAOB Developments, Dec. 6, 2017.
- [9] AS 1215.15.
- [10] AS 1215.16.
- [11] See PCAOB Rules 4006 and 5110.
- [12] See e.g., *United States v. Deloitte LLP*, 610 F.3d 129, 142 (D.C. Cir. 2010); *In re Weatherford Int’l Sec. Litig.*, No. 11CIV1646LAKJCF, 2013 WL 12185082, at *5 (S.D.N.Y. Nov. 19, 2013).
- [13] If the client is involved in the health care industry, such as a hospital or health insurer, it is possible the HIPAA Privacy Rule may require the firm’s client and ultimately the firm to protect individuals’ medical records and other personal health information through redaction of such information in the work papers or other documents to be produced to the PCAOB.
- [14] See *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289, 306-07 (6th Cir. 2002) (not permitting selective waiver of work-product material to government agencies); *In re Initial Pub. Offering Sec. Litig.*, 249 F.R.D. 457, 465-67 (S.D.N.Y. 2008) (finding that company waived work-product protection by disclosure of memoranda to the SEC, which was investigating the possibility of the company’s wrongdoing, to limit liability for that wrongdoing); *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).
- [15] *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) (magistrate judge held that a law firm waived privilege over its interview memoranda and interview notes by providing the SEC with “oral downloads” of the interviews, which the court concluded were the “functional equivalent” of disclosing the memoranda and notes).
- [16] “Policy Statement Regarding Credit for Extraordinary Cooperation in Connection With Board Investigations,” PCAOB Rel. No. 2013-003 (April 24, 2013).
- [17] *Id.*
- [18] *In the Matter of Şule Firuzment*, PCAOB Rel. No. 105-2017-052 (Dec. 19, 2017); *In the Matter of Berkman Özata*, PCAOB Rel. No. 105-2017-051 (Dec. 19, 2017); *In the Matter of DRT Bagimsiz Denetim ve Serbest Muhasebeci Mali Musavirlik AŞ*, PCAOB Rel. No. 105-2017-050 (Dec. 19, 2017).
- [19] “PCAOB Announces \$750,000 Settlement with Deloitte Turkey,” PCAOB Press Release, (Dec. 20, 2017).
- [20] *Id.*
- [21] *In the Matter of Baum & Co. PA and Joel S. Baum, CPA*, PCAOB Rel. No. 105-2018-002 (Feb. 27, 2018).
- [22] *Id.* at pp. 6-7.
- [23] PCAOB Rule 5101, *Commencement and Closure of Investigations*.
- [24] PCAOB Rule 5109(a), *Rights of Witnesses in Inquiries and Investigations*.
- [25] See e.g., *In the Matter of Crowe Horwath (HK) CPA Ltd.*, PCAOB Rel. No. 105-2017-031 (July 25, 2017).
- [26] See PCAOB Rules 5102 and 5103.
- [27] See *SEC v. Whitman*, 613 F. Supp. 48, 49 (D.D.C. 1985).
- [28] *Laccetti v. Securities and Exchange Commission*, 885 F.3d 724, Mar. 23, 2018.
- [29] *Id.* at 725.
- [30] *Id.* at 727.
- [31] *Whitman*, 613 F. Supp. at 49.

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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