

Managing the PCAOB Formal Investigation Process

A PCAOB investigation can be time-consuming and expensive, taking years through the investigation, litigation, and appeals process.

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In an article for the Spring 2018 edition of the *Professional Liability Litigation* newsletter, I provided some tips on “How to Respond to a PCAOB Informal Request” as part of managing the informal inquiry phase of a Public Company Accounting Oversight Board (PCAOB) investigation. This article provides an overview of the next phase of a PCAOB investigation: the formal investigation. A PCAOB formal investigation shares many similarities with investigations by the Securities and Exchange Commission (SEC).

Initiation of a Formal Investigation

An informal inquiry becomes a formal investigation through the board’s issuance of an order of formal investigation (OFI) at the request of the director of the Division of Enforcement and Investigations (DEI) or the director of the Division of Registration and Inspections (DRI) or at the board’s own initiative. Almost all formal investigations are at the request of DEI.

The OFI is usually a one- to two-page document that lists the potential PCAOB standards and rules and securities laws that DEI staff believe the firm and/or associated person(s) may have violated. The OFI will not provide factual details but will at least provide some insight into the DEI staff’s thinking about potential violations.

A horizontal banner advertisement for Western Alliance Bank. On the left is the Western Alliance Bank logo, which includes the letters 'WA' in a stylized font, followed by the text 'Western Alliance Bank' and 'Member FDIC'. To the right of the logo is the text 'Supporting all phases of the settlement process from ESCROW through DISTRIBUTION.' Further right is a photograph of three people in business attire (two men and one woman) in a professional setting. On the far right of the banner is a dark rectangular button with the white text 'LEARN MORE'.

There are two primary reasons why the DEI seeks an OFI from the board: (1) based on the factual record developed through the informal inquiry, there appears to have been one or more violations of PCAOB rules or standards or the securities laws; or (2) there are unreasonable delays and stalling tactics or refusals to respond by an accounting firm

and/or accountants who have received requests for documents, information, interviews, or testimony.

In the first instance, through a review of documents and information provided by the firm or individuals, DEI staff have concluded that there appears to be one or more violations by the audit engagement team during an audit of an issuer or broker-dealer. PCAOB Rule 5101(a) provides thus:

Upon the recommendation of the Director of Enforcement and Investigations or the Director of Registration and Inspections, or upon the Board's own initiative, or otherwise, the Board may issue an order of formal investigation when it appears that an act or practice, or omission to act, by a registered public accounting firm or any person associated with a registered public accounting firm may violate any provision of the Act, the Rules of the Board, the provisions of the securities laws as relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards.

In the second instance, DEI staff have recommended the issuance of an OFI as a result of stonewalling tactics by the firm and/or associated persons. In an informal inquiry, cooperation is voluntary. DEI staff have no enforcement mechanism to compel a firm or accountant to comply with an informal request for documents, information, an interview, or testimony. In a formal investigation, the firm and associated persons are subject to the duty to cooperate with a PCAOB formal investigation under Rule 5110. The board may institute a disciplinary proceeding pursuant to Rule 5200(a)(3) for noncooperation with an investigation where a firm fails to comply with DEI requests for documents, information, or testimony.

Typically, a firm will learn that an informal inquiry has become a formal investigation as a result of receiving an accounting board demand (ABD) under Rule 5102 or 5103. DEI staff have authority under the OFI to issue an ABD for testimony under Rule 5102 or for documents under Rule 5103.

The firm or individual who is compelled to testify or produce documents under an ABD must, upon request, be shown the OFI. Under Rule 5109, the firm can request a copy of the OFI from the DEI director, and it is in the discretion of the director to grant or deny the request. Rule 5109(a) states thus:

Any person who is compelled to testify or produce documents pursuant to a subpoena issued pursuant to Rule 511, or who testifies or produces documents pursuant to an accounting board demand or request, shall, upon request, be shown the Board's order of formal investigation. In 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.

Responding to an ABD for Documents

The ABD for documents and information will presumably not be the first time that DEI staff have asked the firm for documents. If the investigation involves one or more audit years, the DEI will have previously requested the audit work papers in the informal inquiry stage.

The ABD may include new requests for documents, though. In addition, the ABD may include requests for information that will bear a resemblance to interrogatories in civil litigation. These requests, along with the OFI, will provide additional clues as to the DEI staff's focus in the investigation.

In "How to Respond to a PCAOB Informal Request," I provided several tips and suggestions for responding to DEI document and information requests; those tips and suggestions are equally applicable in the formal investigation phase, so I will not repeat them here. However, I will reiterate the importance of reviewing the archived work papers to look for alteration of the work papers after archiving. PCAOB Auditing Standard 1215 sets forth the specific requirements regarding firms' alterations of archived work papers past the 45-day archival period. To date, the DEI has been focused like a laser on evidence of improper work paper alterations. There have been several settled orders in recent years sanctioning firms for improper work paper alteration, including the largest civil money penalty to date of \$8 million, which was imposed against Deloitte's Brazilian affiliate in 2016. *See In re Deloitte Touche Tohmatsu Auditores Independentes*, PCAOB Rel. No. 105-2016-031 (Dec. 5, 2016). The firm should review metadata associated with its work papers at the start of any DEI investigation to determine whether it has an issue in this area. In a settled order sanctioning Deloitte's affiliate in Turkey for work paper alteration, the board gave extraordinary cooperation credit, which resulted in reduced sanctions. *See In re DRT Bagimsiz Denetim ve Serbest Muhasebeci Mali Musavirlik A.S.*, PCAOB Rel. No. 105-2017-050 (Dec. 19, 2017).

Testimony

Under Rule 5102, the DEI may issue an ABD for testimony of any person associated with a registered accounting firm. This includes former employees of the firm. Typically, the DEI will include document requests in the ABD that will be largely identical to the document requests in a document ABD pursuant to Rule 5103. This is to ensure that the DEI is able to obtain documents in the individual's possession that are not in the possession of the firm (i.e., notes, personal emails, etc.) and therefore would not have been previously produced.

DEI testimony shares some similarities with a civil deposition. Testimony is taken under oath and is transcribed by a court reporter. Testimony may be videotaped but usually is not. Counsel for the firm / associated person is permitted to be present. Under Rule 5102(c)(4), DEI staff can take testimony from a person designated by the firm with knowledge on certain topics set forth in the ABD. This procedure is similar to a Rule 30(b)(6) deposition of an entity's designee under the Federal Rules of Civil Procedure.

DEI testimony also shares some differences with a civil deposition. The biggest difference is that, unlike the Federal Rules of Civil Procedure, which limit a deposition to one day of seven hours (Fed. R. Civ. Proc. 30), there is no time limit to DEI testimony. Testimony of a single witness can go for multiple days, particularly for key witnesses such as the engagement partner or manager. In addition, DEI staff can recall a witness for further testimony, even months after the witness initially testified. Another difference is that while a DEI attorney will usually take the lead in conducting testimony, other DEI staff, including other lawyers and accountants, can interject to ask questions or lead testimony in certain topic areas (i.e., journal entry testing, inventory testing, independence issues, etc.).

Other individuals may also attend testimony. For example, if the SEC has a parallel investigation and an information-sharing agreement with the PCAOB, personnel from the SEC's Enforcement Division may attend the testimony of witnesses. Until recently, the DEI usually would not permit firms to bring an expert to testimony. However, on March 23, 2018, in *Laccetti*, the U.S. Court of Appeals for the D.C. Circuit ruled that the right to counsel in a PCAOB investigation also includes the ability to have an expert present to assist counsel. *See Laccetti v. Sec. & Exch. Comm'n*, 885 F.3d 724 (D.C. Cir. 2018). This decision brings PCAOB investigations in line with SEC investigations, which have permitted experts to provide assistance to defense counsel in interviews or testimony since the 1985 *Whitman* decision. *See SEC v. Whitman*, 613 F. Supp. 48, 49 (D.D.C. 1985). It also levels the playing field between DEI staff conducting testimony and defense counsel. Counsel should consider the potential benefits of having an expert attend to assist

counsel at testimony. Pursuant to Rule 5102(c)(3), counsel can submit a letter requesting attendance of the expert at testimony.

After the conclusion of testimony, the court reporter will prepare a transcript. Under Rule 5102(d), a witness has 15 days after being notified that the transcript is available to review the transcript, make changes in form or substance, and sign a statement reciting such changes and the reasons given by the witness for making them. Under Rule 5109(c), counsel for the firm / associated person may procure a copy of the transcript via written request to DEI staff and payment of associated costs to the court reporter.

Charging, Statement of Position, and Offer of Settlement

If DEI staff believe that there is a sufficient evidentiary record supporting a finding that one or more violations have occurred, DEI staff, in consultation with DEI senior management, will charge the firm and/or associated person(s). The charging process can be conducted through a charging call conducted by DEI staff assigned to the investigation or through a charging letter that sets forth in detail the charges and the supporting facts for each of the charges.

The charged firm or person will be given the opportunity under Rule 5109(d) to submit a statement of position. The statement of position is similar to a Wells submission to the SEC. A firm or associated person under investigation can submit a statement of position at any time in an informal inquiry or investigation. However, firms usually wait until after receiving a charging letter to submit a statement. The statement of position is the firm's last opportunity to persuade DEI staff either to not institute a disciplinary proceeding or to narrow the violations to be charged in the disciplinary proceeding. Under Rule 5109(d), the statement of position is forwarded to the board in conjunction with a staff recommendation regarding instituting disciplinary proceedings. However, defense counsel should weigh any potential downside to previewing its defenses if counsel believes that there is little chance of persuading DEI staff either to not recommend instituting proceedings or to narrow the charges.

Alternatively, a firm may decide to pursue settlement discussions with DEI staff. If the firm and staff reach a settlement, DEI staff will usually draft a proposed offer of settlement. Under Rule 5205, a firm or person may propose a written offer of settlement to the DEI. Usually the order is on a neither-admit-nor-deny basis. On occasion, the DEI may seek admissions where auditors find egregious conduct or where heightened accountability and acceptance of responsibility are in the public interest. The offer of settlement is signed by the person making the offer, not by counsel, and submitted to

the director of the DEI. The DEI then presents the offer of settlement to the board with its recommendation; however, if the recommendation is unfavorable, the offer is not presented to the board unless the firm or person making the offer requests that it be presented.

Conclusion

A PCAOB investigation can be time-consuming and expensive, taking years through the investigation, litigation, and appeals process. It is important to understand PCAOB's informal and formal investigation process to better represent clients in investigations; to help the client understand the process; and to effectively consider potential opportunities to persuade staff to close an investigation earlier in the process or, where violations have occurred, to engage in early resolution.

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