

THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 47 No. 3 February 5, 2014

PREPARING AN EFFECTIVE PCAOB STATEMENT OF POSITION

A Statement of Position submitted on behalf of a respondent in a PCAOB disciplinary investigation is an argument – like a “Wells” submission in an SEC investigation – why the agency should not go ahead with an enforcement action. The authors discuss strategic considerations for defense counsel in the SOP process. They then turn to the comments of senior PCAOB enforcement staff on four common defense themes found in SOPs and why these, as usually formulated, may not be helpful to respondents. They close with some additional SOP practice tips.

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Defending an investigation and enforcement proceeding brought by the Public Company Accounting Oversight Board, a nonprofit entity established by Congress to oversee the audits of public companies and broker dealers, can have several phases. One critical phase of the process is the preparation of a PCAOB Rule 5019(d) statement of position (“SOP”) on behalf of an accounting firm or an individual auditor. A successful SOP can persuade the staff of the PCAOB’s Division of Enforcement and Investigations to terminate its investigation without recommending formal charges against the accountant or firm. Even if the staff is not persuaded to forego such a recommendation, the SOP will serve as an opportunity to advocate before the PCAOB board members why the board should decline to authorize disciplinary proceedings. An effective SOP can also be important in negotiating a favorable settlement, if appropriate.

This article provides an overview of the PCAOB’s SOP process and the relevant PCAOB rules that should

inform the development of defense arguments. It then discusses recent comments made by high level PCAOB enforcement staff regarding the importance they place on the SOP process, as well as their view of four common defense themes often raised in SOPs. The staff’s remarks provide important insights and suggestions for defense counsel to consider when preparing an SOP. Finally, this article presents additional practice tips, including suggestions by senior enforcement staff, to consider when preparing an SOP.

OVERVIEW OF THE SOP PROCESS AND RULE 5109(D)

A PCAOB SOP is similar to a *Wells* submission made during the Securities and Exchange Commission’s *Wells* process. If the staff of the PCAOB’s Division of Enforcement and Investigations concludes from its investigation that violations of the PCAOB’s rules have occurred and a formal disciplinary proceeding should

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commence, the staff will notify the subject of the investigation (“respondent”) that it intends to recommend to the PCAOB board that disciplinary proceedings be instituted. The respondent may then provide a written submission addressing the alleged violations that the staff has identified. PCAOB Rule 5109(d) governs this process:

Registered public accounting firms, and persons associated with firms, who become involved in an informal inquiry or a formal investigation may, on their own initiatives, submit a written statement to the Board setting forth their interests and positions in regard to the subject matter of the investigation. Upon request, the Board’s staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to those persons and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Board for the commencement of a disciplinary proceeding. In the event a recommendation for the commencement of a disciplinary proceeding is presented by the staff, any submissions by interested persons will be forwarded to the Board in conjunction with the staff recommendation.

While Rule 5109(d) does not require the PCAOB staff to notify the subject that it intends to recommend disciplinary proceedings, in practice the staff routinely provides such notice, describes the nature of the alleged violations, and offers the subject of the potential disciplinary proceedings an opportunity to submit an SOP. The staff’s notice designates a relatively short period of time – in our experience two to four weeks absent an extension of time – for the respondent to submit an SOP pursuant to Rule 5109(d). If upon review of the SOP the staff maintains its belief that disciplinary proceedings are warranted, it will forward to the board both the respondent’s SOP and the staff’s recommendation. If the board elects to commence a

disciplinary proceeding,¹ it will issue a written order instituting proceedings (“OIP”), which operates as the administrative complaint,² and a hearing officer will be assigned to preside over the proceeding.³

PREPARING AN EFFECTIVE SOP

Preparing an effective SOP necessarily requires a number of strategic and practical considerations. A threshold consideration, of course, is whether to submit any SOP. The risk in doing so is to disclose the position of the defense earlier than one would ordinarily do in litigation, allowing the staff to modify its allegations prior to filing its complaint and otherwise to prepare its case for hearing. That said, both parties submit pre-hearing briefs in a disciplinary proceeding. Furthermore, the SOP provides an opportunity to persuade the staff or the board not to commence proceedings in the first place, or to narrow the allegations on which it ultimately proceeds. This is a potentially significant upside of submitting an SOP given the potential time and resources required to defend against a disciplinary proceeding, not to mention the high stakes involved for an individual auditor or accounting firm.⁴

¹ See PCAOB Rule 5200.

² See PCAOB Rule 5201(b) (requiring in the OIP “a short and plain statement of the matters of fact and law to be considered and determined with respect to each person charged, including - (1) . . . (i) the conduct alleged to have violated the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports, or the obligations and liabilities of accountants with respect thereto, including the rules of the Commission under the Act and professional standards; and (ii) the rule, statute, or standard violated”).

³ On October 23, 2013, the PCAOB named Marc B. Dorfman as Chief Hearing Officer. Senior Hearing Officer David M. FitzGerald, who served as Chief Hearing Officer since January 2009, is retiring from the Board.

⁴ See generally PCAOB Rules 5300(a) & 5301 (possible sanctions include revocation of an accounting firm’s registration, a bar of an individual’s ability to associate with a registered public accounting firm, and civil money penalties).

If the decision is made to submit an SOP, among the strategic factors to consider are the various potential audiences and the most important objective of the submission; these necessarily depend on the peculiar circumstances of the investigation at issue. The immediate audience is the staff, including both accountants and attorneys involved in the investigation, as well as senior enforcement staff, any of whom may be persuaded by an effective SOP to reconsider, narrow, or otherwise modify the staff's recommendation to the board. If the staff presses its recommendation to the board, then the board will review the SOP. The board comprises both attorney and accountant members, and it will review the SOP in the context of the staff's submission and through a prism that likely includes precedential and policy considerations. Therefore, it can be important for the SOP both to address any misinterpretation of audit standards or misconstruction of the factual record underlying the staff's allegations, and to explicate compelling policy reasons why the board should not institute disciplinary proceedings.

Finally, if the matter proceeds to a disciplinary hearing, the SOP can be admitted as evidence by the staff. Consequently, another potential audience of the SOP that should be considered is the hearing officer and the staff's audit and accounting expert(s).

The Views of PCAOB Enforcement Staff

Claudius Modesti, Director of the PCAOB Division of Enforcement and Investigations, and Jarrett Decker, Deputy Director and Chief Trial Counsel of the PCAOB Division of Enforcement and Investigations, recently shared their perspectives⁵ on the SOP process and common defenses at the 2013 American Law Institute conference, *Accountants' Liability: Managing Risks in a Changing Environment* in Washington, DC. The conference was co-chaired by Veronica Rendón, Co-Chair of Arnold & Porter LLP's Securities Enforcement and Litigation Practice.

Mr. Decker emphasized the importance the staff places on the SOP in determining whether to recommend a disciplinary proceeding, noting that the SOP process has resulted in the staff's decision not to recommend disciplinary proceedings in certain cases. He explained that the staff, including members with public accounting experience, gets "into the weeds" of the allegations and SOP responses to ensure an understanding of all the accounting and auditing issues. In that regard, despite

⁵ Mr. Modesti and Mr. Decker expressed their own views and not necessarily the views of the PCAOB.

Rule 5109(d)'s reference to notice of "the general nature" of the investigation and alleged violations, he said that the staff's practices have changed over time such that it now often gives detailed notice of the potential allegations. As a result of the more detailed notice, the staff tends to receive SOPs that contain more detailed responses.

Understanding the PCAOB's objective of protecting investors by promoting compliance with audit standards is also critical to preparing an effective SOP. As Mr. Decker underscored, the goals of the Staff are "very different" from those of plaintiff's counsel in private litigation, and the elements of proof in a PCAOB disciplinary proceeding are different from those in a civil accounting malpractice or securities fraud case. Certain arguments that Mr. Decker routinely sees in SOPs are not considered relevant to the staff's determination because of these distinctions. For example, because the PCAOB may impose sanctions for violations of professional standards,⁶ the staff has taken the position that it is not required to prove that an accountant's alleged negligence or violation of professional audit standards caused the audit client's financial statements to be materially misstated.

Mr. Decker also commented on four common defense themes that the staff sees in SOPs: (1) the "management committed fraud" defense, (2) the materiality defense, (3) the "we did enough" defense, and (4) the so-called "role defenses" related to the particular accountant's role on the audit at issue.

1. *The Management Fraud Defense.* Mr. Decker often reads in SOPs "very lurid" descriptions of management's fraudulent acts. Specifically, SOPs commonly set forth a detailed description of the facts and documents that company management withheld from the auditors, and then emphasize that even a compliant audit "may not detect a material misstatement" or fraud, citing AU Section 230, *Due Professional Care in the Performance of Work.*⁷

The fact of management fraud, by itself, is irrelevant to the staff's decision whether to recommend disciplinary proceedings. Mr. Decker explained that the auditor has a duty to obtain "reasonable assurance" as the basis for the audit opinion,⁸ and management fraud

⁶ See Rule 5300(a).

⁷ AU § 230.12 ("Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement.").

⁸ AU § 110.02.

does not relieve the auditor of that duty. In other words, if the auditor's conduct resulted in a violation of PCAOB audit standards, then the staff will not be persuaded by arguments that even if the auditor had complied with the standard at issue, the auditor still would not have uncovered the fraud. As Mr. Decker emphasized, the staff's burden is to prove that the auditor did not comply with professional standards, not that the audit should have uncovered the fraud. To illustrate his point, Mr. Decker addressed the hypothetical of a management fraud so pervasive that even if the audit team had confirmed receivables, management and its customer would have colluded to provide the auditors with a fabricated audit confirmation in order to conceal the fraud. In such a case, Mr. Decker explained, the management fraud would not itself have excused the auditor's failure to confirm receivables. Likewise, he noted, the fact that a management representation letter contained fraudulent representations would not be persuasive to the staff if the auditor failed to test management representations in accordance with AU Section 333, *Management Representations*.⁹

However, according to Mr. Decker, management fraud may be relevant to the extent it actively hindered the audit. For example, if in the above hypothetical the auditors did perform confirmations of customer receivables, but management colluded with the company's customers to submit to the auditors inaccurate accounts receivable confirmations, the staff would consider that collusion in evaluating the reasonableness of the auditor's conduct.

2. *The Materiality Defense*. A second common theme in SOPs is what Mr. Decker characterized as an after-the-fact materiality defense based on broad materiality arguments. For example, respondent might assert that because the financial statement account in question (e.g., an accounts receivable reserve) was only a small percentage of total revenues, it was immaterial to the audit. According to Mr. Decker, the staff considers materiality as part of its decision to recommend charges, and it considers materiality in terms of what information was available to the auditor at the time. Indeed, Mr. Modesti noted that it is uncommon for the PCAOB to recommend charges involving areas that the audit team did not identify as high risk. Because the staff is interested in knowing whether the auditor considered the

account material at the time of the audit, Mr. Decker suggested that comparisons to total revenues generally are not helpful. Instead, he suggested that an effective SOP should identify audit workpapers or other documentary evidence that demonstrate the materiality or risk assessments that the auditors made at the time of the audit, including why the auditor concluded that an account or item was not material.

3. *The "We Did Enough" Defense*. Another common defense argument is that the audit procedures performed were adequate, based on the fundamental auditing principle that the audit opinion is based on reasonable, not absolute, assurance.¹⁰ According to Mr. Decker, however, the staff usually recommends disciplinary proceedings when the audit record raises specific questions about whether the auditor obtained sufficient evidence to obtain reasonable assurance. Mr. Decker provided as examples unaddressed questions regarding the sufficiency of reserves or audit judgments regarding the valuation of an asset based on stale or incomplete information. In the staff's view, such issues are those for which a reasonable auditor would seek substantial audit evidence not reflected in the audit workpapers.

A typical formulation of a "we did enough" argument that Mr. Decker does not find persuasive is a broad explanation of the procedures the auditor performed that have little relevance to the issues the staff raised, and a conclusion that therefore the audit evidence was sufficient. Mr. Modesti added that SOPs typically highlight the corroborating evidence documented in the workpapers but fail to address the contradictory audit evidence. He underscored that the staff is particularly interested in knowing whether and what the auditor did to overcome any contradictory evidence, or why that evidence is, in fact, not contradictory.

Mr. Decker suggested that a persuasive SOP will explain why the audit evidence the auditor did obtain answered the question raised by the staff (e.g., whether the reserve is sufficient), or will explain how, looking at the full context of the audit, the question raised by the staff was one that properly would not have been raised during the audit (e.g., the audit procedures performed on the revenue account were sufficient in light of results of audit procedures performed on the accounts receivable account).

4. *Role Defenses*. The final common defense theme Mr. Decker identified was a so-called "role defense," in which the auditor asserts that a disciplinary proceeding

⁹ AU § 333.02 ("[R]epresentations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.").

¹⁰ See, e.g., AU § 110.02.

is not warranted or appropriate given her role on the audit team. For example, a concurring review partner might argue that she did not, and had no responsibility to, review the particular audit area or workpaper in question. Similarly, an engagement partner or manager might argue that she was not aware of the issue because it was in an area that she did not review. Mr. Decker advised that if a concurring reviewer was not put on notice of a particular issue, then that should be explained in the SOP. And the SOP should address why it was reasonable for the engagement partner or manager not to have reviewed a particular workpaper or otherwise known of the issue in question.

Additional SOP Practice Tips

In addition to the considerations identified by the PCAOB staff described above, there are other factors defense counsel should consider when preparing an effective SOP.

Admissibility of SOP. As noted above and as the staff's written notice letters advise, it is important to keep in mind that the SOP can be admitted as evidence by the staff in any disciplinary proceeding that is instituted. Thus, it is important that counsel have undertaken its factual investigation and developed its theory of the case as fully as possible prior to preparing the SOP. During the disciplinary hearing, the staff may highlight any perceived inconsistencies between arguments set forth in the SOP and the defenses advanced during the hearing in an effort to discredit the respondent's position.

Contemporaneous Documentary Evidence. As Mr. Decker alluded to in his remarks, the staff places significant weight on contemporaneous audit judgments, whether related to materiality assessments or the sufficiency of competent audit evidence. Therefore, it can be important to cite audit workpapers or other documentary evidence of contemporaneous audit judgments, audit procedures performed, and audit evidence obtained. The staff may be more likely persuaded by arguments that the auditors reasonably exercised professional judgment in compliance with audit standards – including audit documentation standards¹¹ – if such arguments are supported by contemporaneous documentary evidence.

Expert Reports. Counsel should also consider whether it would be effective to submit a supporting expert report with the SOP. According to Mr. Decker,

an expert report at the SOP stage is particularly relevant to the staff when specialized knowledge is necessary, such as technical accounting interpretations, or specific industry practice or expertise. However, Mr. Decker offered that an expert report that simply states in a conclusory manner that the audit was performed in accordance with audit standards, even if submitted by a well-regarded auditing expert, typically will not influence the staff's determination.

If counsel concludes that it might be helpful to submit an expert report at the SOP stage, both strategic and practical issues must be considered. There are potential and considerable benefits of an expert opinion in helping to persuade the staff to terminate its investigation or to set the stage for early settlement. Counsel must weigh these benefits against any potential downsides of providing the staff with a preview of respondent's expert case, mindful that the PCAOB rules of procedure do not provide for expert discovery. There is also the risk of locking in an expert early, even before the complaint is filed. For example, with the benefit of more time to consider the record, an expert may have new thoughts and opinions, and additional facts may be developed during the course of preparing for the hearing. An expert can submit another expert report in connection with the hearing, but such facts and additional thoughts might be developed and incorporated more easily into the defense if the expert has not already submitted a report with the SOP. Also, depending on the ultimate charges filed by the staff, a different or additional expert may be necessary for the hearing. For all of these reasons, and because an expert report submitted with an SOP may be admitted into evidence during a subsequent hearing in the matter, the scope of any expert report should be carefully considered.

As a practical matter, counsel should consider retaining an expert even prior to receiving notice from the staff that it intends to recommend disciplinary proceedings. This may be especially true if the investigation appears to concern compliance with general standards of due care or professional skepticism, or the sufficiency of audit procedures, as opposed to a more narrow technical accounting interpretation. If it is contemplated that an expert report might address broader issues of audit standard compliance, early retention of experts may be important to ensure that the expert has sufficient time to reach a fully considered conclusion and to prepare a written report within the timeframe provided for submitting an SOP.

SOP Appendix. Mr. Modesti encouraged respondents to submit with their SOPs an appendix of cited

¹¹ PCAOB Auditing Standard No. 3, *Audit Documentation*.

workpapers and other documents. Although most documents included in such an appendix will have been produced to the staff previously during the course of the investigation, workpaper and other productions during PCAOB investigations are often voluminous, and the format and organization of each audit firm's workpapers differ. Submitting an appendix with an SOP will make it easier for the staff to review the supporting evidence and may thereby enhance the persuasiveness of respondent's arguments.

Follow-up Conversation with the Staff. Finally, it is important that counsel follow up with the staff after submitting the SOP and request a meeting to discuss the matter. In our experience, the staff generally is amenable to such a meeting, and Mr. Modesti commented that he is often surprised when counsel fails to make such a request. A follow-up meeting can be critical, as it gives counsel an opportunity to address questions that the staff may have after reviewing the SOP and to gauge the staff's reaction to the positions articulated in the SOP. It also provides an opportunity to open a dialogue – including with more senior staff if warranted – regarding potential resolution of the matter, including possible settlement if appropriate. Depending

on the nature of the follow-up conversation with the staff, counsel should also consider whether a supplemental submission would be useful and appropriate.

CONCLUSION

There are many important strategic and practical considerations involved in preparing an effective SOP. Of course, even the most well-presented and supported SOP may not persuade the staff – which may have invested substantial time and resources in its investigation – to recommend against commencing a disciplinary proceeding. It is therefore important to consider that the PCAOB staff is one of several potential audiences for an SOP. An effective SOP will be written with each of the various audiences in mind, including senior enforcement staff, as well as the PCAOB board members who have ultimate decision-making authority. Thus, while certain of the staff's views of effective and ineffective SOP arguments are set forth above, counsel must consider the particular allegations, factual issues, and broader policy implications raised by any particular case when determining the best defenses to advance in an SOP. ■