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# New PCAOB Admissions Policy Alters The Settlement Equation

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Law360, New York (October 19, 2015, 2:21 PM ET) -- On Oct. 2, 2015, Claudius Modesti, the director of the Division of Enforcement and Inspections at the Public Company Accounting Oversight Board, announced that the PCAOB would now "consider requiring admissions in appropriate matters where heightened accountability and acceptance of responsibility are in the public interest."<sup>[1]</sup> On the same day, the PCAOB announced the settlement of an action against David A. Aronson, CPA, and his accounting firm.<sup>[2]</sup> As part of the settlement, Aronson and his firm admitted to the facts, findings and violations set forth in the order — the first PCAOB disciplinary order to contain such admissions.

Modesti's announcement follows the implementation of an admissions policy by the U.S. Securities and Exchange Commission in June 2013, pursuant to which the SEC has sought admissions in certain settlements. The SEC continues to press forward in this direction, signaling a focus by both regulators in seeking admissions in instances — such as Aronson — where the conduct is considered particularly egregious.

## New PCAOB Admissions Factors

In his remarks, Modesti announced that, in deciding whether to seek admissions, the Division of Enforcement and Inspections ("DEI") will consider, among other factors, the following:

- "Egregious and intentional misconduct where the respondent knowingly and intentionally violated the applicable laws, rules or standards;
- Misconduct that obstructs the board's processes, such as noncooperation with an inspection or an investigation;
- Significant harm or risk of harm to investors or the securities markets;
- Situations where an admission can send a particularly important message to audit firms, their associated persons or to the public; and

- Situations where the wrongdoer poses a particular future threat to investors, e.g., recidivists.”

While the DEI “anticipates that most of its settlement recommendations will continue to include language stating that the respondent has neither admitted nor denied the Board’s finding,” these factors indicate the DEI’s willingness to seek admissions in instances, such as Aronson, where, for example, an auditor or registered accounting firm ignores multiple PCAOB inspection findings and continues to engage in rule violations.

***In the Matter of David A. Aronson***

In the settled disciplinary order, the PCAOB censured and revoked the registration of registered public accounting firm David A. Aronson, CPA, PA, and also censured and barred David A. Aronson, the sole owner and only member of the firm.[3] The firm and Aronson admitted to all the facts, findings and violations set forth in the order, which also noted that “[t]he findings herein are made pursuant to the Respondents’ Offers and are not binding on any other person or entity in this or any other proceeding.”[4] Such a qualification was likely included because the order identifies the names of the public issuer clients involved. While issuers are not under the PCAOB’s jurisdiction, if the admissions were somehow construed as admissions of the identified issuers, it might result in investors attempting to use the admissions in any follow-on litigation arising out of the audits.

The facts admitted by Aronson and his firm, in relevant part, were as follows:

- PCAOB Auditing Standard No. 7, Engagement Quality Review (“AS 7”), requires that an engagement quality review must be performed on any audits and interim reviews conducted pursuant to PCAOB standards.[5]
- The firm issued audit reports for two different issuer audit clients for fiscal year 2010 without obtaining an engagement quality review.[6] The issuers subsequently filed a Form 10-K, incorporating the audit reports, with the SEC.[7]
- In June 2011, PCAOB inspectors identified failures by the firm to comply with AS 7 on certain engagements.[8] In the firm’s response to the PCAOB’s findings, it “agreed that AS 7 requires an engagement quality review and concurring approval of issuance for audit engagements conducted pursuant to PCAOB standards.”[9]

- The firm then issued audit reports for four different issuer audit clients for fiscal years 2011, 2012 and 2013 without obtaining an engagement quality review.[10] Those reports were all incorporated into Forms 10-K filed by the issuer clients.
- In early March 2014, the PCAOB inspectors again informed the firm of its failure to comply with AS 7 on certain engagements.[11]
- In March and April 2014, the firm, without obtaining an engagement quality review, permitted the issuance of fiscal year 2013 audit reports and the inclusion of those reports in Forms 10-K filed by three different issuer audit clients.[12]
- In March 2015, as part of a DEI inquiry into the audit reports issued by the firm, the DEI notified the firm again of its repeated failures to comply with AS 7.[13]
- In April 2015, the firm permitted the issuance of an unqualified audit report for fiscal year 2014 and inclusion of that report in a Form 10-K filing by an issuer audit client despite not obtaining an engagement quality review.[14]

It appears that the PCAOB sought admissions from the firm and the sole owner in settling the action given the number of times the PCAOB identified the firm's failure to comply with AS 7 and the number of times (10) the firm issued audit reports without obtaining the requisite engagement quality review, including when it was under inspection and subject to an outstanding enforcement inquiry.

Additionally, the firm and the auditor admitted to violating Rule 2-01 of Regulation S-X on five of the above-mentioned audit engagements.[15] Rule 2-01, which sets forth the auditor's independence obligations for issuer audits and is incorporated as part of the PCAOB standards, prohibits close family members of an accountant, such as an accountant's nondependent child, from serving in an accounting role at an audit client during the period covered by the audit.[16]

Aronson's son owned a bookkeeping firm, which Aronson recommended to four of his issuer audit clients described above.[17] Aronson's son thereafter served as the "primary bookkeeper (recording journal entries directly to the clients' general ledgers)" and prepared the financial statements for these clients for fiscal years 2010, 2011, 2012 or 2013, depending on the client. [18] Each of these financial statements were then audited by Aronson and his firm.[19] The PCAOB noted that the son's firm was not a public accounting firm registered with the PCAOB, which could indicate that if the son's firm was registered, it too might have been subject to the order.[20]

## **Considerations and Potential Implications**

How often and under what circumstances the PCAOB will require audit firms or auditors settling enforcement actions to admit to the underlying facts is uncertain. Given the facts in Aronson, it seems likely that the PCAOB will look for admissions if the violations are repeated after agreeing to inspection findings in prior years and not taking any steps to remedy the underlying issue. Aronson arguably involved several of the five factors articulated by Modesti. How many of articulated factors will need to be present in future cases before the PCAOB requires admissions remains to be seen, although it appears that no one factor will be considered in isolation; rather, the facts and circumstances of each matter will be considered.

Furthermore, the considerations underlying whether to admit as part of a settlement may be a particularly difficult one in certain scenarios. For example, admissions by accounting firms regarding alleged audit failures under the PCAOB standards or the SEC independence rules could raise concerns that audit clients or investors might seek to use the admissions in follow-on litigation. Consequently, how the admission is phrased and the conduct described in settlement orders containing admissions may be significant. Additionally, in the case of parallel investigations by the SEC and the PCAOB enforcement staffs, an entity or individual subject to enforcement activity by both regulators may choose to proceed with a contested disciplinary proceeding rather than admit certain violations in a settled order.

The factors that the PCAOB will consider under its new admissions approach are similar to those used by the SEC. Therefore, looking to the SEC's pattern of requiring admissions in certain instances may shed some light on the likelihood an admission could be required as part of a PCAOB settlement. The SEC requires admissions in instances where there are parallel criminal convictions or parallel nonprosecution or deferred prosecution agreements,[21] and it potentially will seek admissions in settlements when the defendant engaged in "egregious intentional misconduct," obstruction of an SEC investigation, or "misconduct that harmed large numbers of investors." [22] The SEC will also seek admissions in instances where there is a "significant risk to the markets or to investors," "the wrongdoer poses a particular future threat to investors or to the markets, and cases in which admissions would meaningfully enhance the deterrence message of the case." [23] The SEC required admissions in a dozen settlements between 2013 and 2014,[24] settling most actions using neither admit nor deny language. Therefore, like the SEC, the PCAOB is

not likely to require admissions as part of a settlement with regularity, and will likely do so only to the extent it meets the criteria set forth by the agency.

It is worthwhile to note that, similar to the SEC, the PCAOB's admission factors contain a consideration for admissions in "[s]ituations where an admission can send a particularly important message to audit firms, their associated persons or to the public." This particular factor may result in the PCAOB seeking admissions in less than egregious situations when the underlying activity intersects with one of the regulator's stated areas of focus. For example, the PCAOB has paid particular attention recently to audits of broker-dealers. This focus may mean that, in the next round of enforcement activity for audit firms and/or auditors working on broker-dealer engagements subject to PCAOB standards, the regulator may seek admissions in order to stress again the importance of audit standard compliance in these engagements.[25] It also may be used to remind registered accounting firms of the importance of cooperating with and responding appropriately to the PCAOB inspection staff.

## **Conclusion**

Whether the PCAOB's decision to seek admissions in certain settlements will substantially change its enforcement practices remains to be seen. In his remarks, Modesti emphasized that the "neither admit nor deny" language will continue to serve an important purpose: "When accompanied by appropriate settlement terms, the without-admitting-or-denying provision is a useful mechanism for promptly resolving matters; this serves investors by more quickly publicizing the nature of the misconduct at issue, requiring the sanctions immediately to take effect, deterring other similarly situated auditors, and freeing enforcement resources for other matters."[26] At the very least, the PCAOB has added another tool to its enforcement arsenal.

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[1] Mr. Modesti made his announcement at the American Law Institute Accountants' Liability Conference 2015: Confronting Enforcement and Litigation Risks (the "Conference"), during a panel chaired by Elissa Preheim, a partner of Arnold & Porter LLP. Veronica Rendón Callahan, co-chair of Arnold & Porter LLP's Securities Enforcement and Litigation Practice, co-chaired the Conference. A copy of Mr. Modesti's comments, Modification to Settlement Recommendations for Disciplinary Proceedings (Oct. 2, 2015), are available at <http://pcaobus.org/News/Speech/Pages/10022015-Modesti-settlement-policy-modification.aspx>.

[2] In the Matter of David A. Aronson, CPA, P.A., and David A. Aronson, CPA, PCAOB Release No. 105-2015-034 (Oct. 2, 2015).

[3] In the Matter of David A. Aronson, CPA, P.A., and David A. Aronson, CPA, PCAOB Release No. 105-2015-03, at 1, 10-11.

[4] Id. at n.1.

[5] Available at [http://pcaobus.org/Standards/Auditing/pages/auditing\\_standard\\_7.aspx](http://pcaobus.org/Standards/Auditing/pages/auditing_standard_7.aspx).

[6] In the Matter of David A. Aronson, CPA, P.A., and David A. Aronson, CPA, PCAOB Release No. 105-2015-03, at ¶¶ 10-13.

[7] Id.

[8] Id. at ¶ 14.

[9] Id.

[10] Id. at ¶¶ 15-21.

[11] Id. at ¶ 22.

[12] Id. at ¶¶ 23-26.

[13] Id. at ¶ 27.

[14] Id.

[15] Id. at ¶¶ 30-32.

[16] See PCAOB Rule 3520, Note 1, available at [http://pcaobus.org/Rules/PCAOBRules/Pages/Section\\_3.aspx#rule3520](http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx#rule3520) (stating registered public accounting firm or associated person with the registered public accounting has "obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the [SEC] under the federal securities laws"); 17 C.F.R. § 220.2-01(c)(2)(ii).

[17] In the Matter of David A. Aronson, CPA, P.A., and David A. Aronson, CPA, PCAOB Release No. 105-2015-03, at ¶ 32.

[18] Id.

[19] Id.

[20] Id. at n.24.

[21] Robert Khuzami, Public Statement by SEC Staff: Recent Policy Change (Jan. 7, 2012), available at <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171489600>.

[22] Dina ElBoghdady, SEC to Require Admissions of Guilt in Some Settlements, The Washington Post (June 18, 2013), available at

[http://www.washingtonpost.com/business/economy/sec-to-require-admissions-of-guilt-in-some-settlements/2013/06/18/9eff620c-d87c-11e2-a9f2-42ee3912ae0e\\_story.html](http://www.washingtonpost.com/business/economy/sec-to-require-admissions-of-guilt-in-some-settlements/2013/06/18/9eff620c-d87c-11e2-a9f2-42ee3912ae0e_story.html).

[23] Mary Jo White, The Challenge of Coverage, Accountability and Deterrence in Global Enforcement (Oct. 1, 2014), available at

<http://www.sec.gov/News/Speech/Detail/Speech/1370543090864>.

[24] Andrew Ceresney, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014), available at

<http://www.sec.gov/News/Speech/Detail/Speech/1370543515297>.

[25] See, e.g., Staff Inspection Brief, Information about 2015 Inspections of Auditors of Brokers and Dealers (Aug. 2015), available at

[http://pcaobus.org/Inspections/Documents/Inspection\\_Brief\\_2015\\_1.pdf](http://pcaobus.org/Inspections/Documents/Inspection_Brief_2015_1.pdf); see also PCAOB News Release, PCAOB Announces Settled Disciplinary Orders and Extraordinary Cooperation Credit in Audits of Broker-Dealers (Jul. 9, 2015), available at [http://pcaobus.org/News Releases/Pages/07092015\\_Enforcement.aspx](http://pcaobus.org/News Releases/Pages/07092015_Enforcement.aspx); PCAOB News Release, PCAOB Announces Settled Disciplinary Orders Against Seven Audit Firms for Independence Violations When Auditing Broker-Dealers (Dec. 8, 2014), available at [http://pcaobus.org/News Releases/Pages/12082014\\_Enforcement.aspx](http://pcaobus.org/News Releases/Pages/12082014_Enforcement.aspx).

[26] Modesti, Modification to Settlement Recommendations for Disciplinary Proceedings, at 2.