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ACCOUNTING

Changing The Settlement Equation - The PCAOB Division of Enforcement and Inspections Implements New Admissions Policy



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On October 2, 2015, Claudius Modesti, the Director of the Division of Enforcement and Inspections (“DEI”) at the Public Company Accounting Oversight Board (“PCAOB” or “Board”), announced a change to DEI policy, explaining that “[g]oing forward, in its settlement recommendations to the Board[,] DEI now will consider requiring admissions in appropriate matters where heightened accountability and acceptance of responsibility are in the public interest.”¹ On the same day, the PCAOB issued an order sanctioning David A. Aronson, CPA, and his accounting firm for repeated violations of auditor independence and engagement quality review requirements.² As part of the settle-

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. 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,

ment, 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.

Mr. Modesti's announcement follows the implementation of an admissions policy by the Securities and Exchange Commission ("SEC") in June 2013, pursuant to which the SEC has sought admissions in several recent settlements.³ In joining the SEC, Mr. Modesti's announcement of the DEI's new policy signals a focus by both regulators in seeking admissions in instances—such as *Aronson*—where the conduct is considered particularly egregious.

The DEI's Admissions Factors

In his remarks, Mr. Modesti identified five non-exhaustive factors that the DEI will consider in determining whether to recommend that the Board require a respondent admit to the facts or the violations detailed in a settlement:

1. "Egregious and intentional misconduct where the respondent knowingly and intentionally violated the applicable laws, rules or standards;
2. Misconduct that obstructs the Board's processes, such as noncooperation with an inspection or an investigation;
3. Significant harm or risk of harm to investors or the securities markets;
4. Situations where an admission can send a particularly important message to audit firms, their associated persons or to the public; and
5. Situations where the wrongdoer poses a particular future threat to investors, e.g., recidivists."

Mr. Modesti's announcement was accompanied by the PCAOB's order in *Aronson*, which provides an example of how the DEI and the Board will apply these factors.

In the Matter of David A. Aronson, CPA, P.A., and David A. Aronson, CPA

The PCAOB's Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions censured and revoked the registration of the public accounting firm David A. Aronson, CPA, P.A., and censured and barred David A. Aronson, the sole owner and member of the firm (collectively, "Aronson").⁴ Aronson admitted to all the facts, findings and violations set forth in the Order,⁵ including the following failures to

2015), available at http://pcaobus.org/Enforcement/Decisions/Documents/David_A_Aronson.pdf.

³ For additional background regarding the SEC's approach to requiring admissions as part of settlements, please see *SEC Announces New Enforcement Initiatives*, Arnold & Porter LLP Advisory (July 2013), available at <http://www.arnoldporter.com/resources/documents/ADV713SecAnnouncesNewEnforcementInitiatives.pdf>.

⁴ *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.

⁵ *Id.* at n.1. The Order 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," which likely was included because the Order identified the names of the public issuer clients involved.

comply with PCAOB Auditing Standard No. 7, *Engagement Quality Review* ("AS 7"), which requires that auditors perform engagement quality reviews on any audits and interim reviews conducted pursuant to PCAOB standards.⁶

- The firm issued audit reports for two different issuer audit clients for fiscal year 2010 without obtaining an engagement quality review.⁷ The issuers subsequently filed a Form 10-K, incorporating the audit reports, with the SEC.⁸
- In June 2011, PCAOB inspectors identified failures by the firm to comply with AS 7 on certain engagements.⁹ 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."¹⁰
- 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.¹¹ 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.¹²
- 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.¹³
- 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 7.¹⁴
- 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

⁶ Available at http://pcaobus.org/Standards/Auditing/pages/auditing_standard_7.aspx. It is worthwhile to note that, in the context of a sole practitioner like Aronson, AS 7 permits the engagement quality reviewer to be "an individual from outside the firm." *Id.* at ¶ 3; *id.* at n. 2 ("An outside reviewer who is not already associated with a registered public accounting firm would become associated with the firm issuing the report if he or she (rather than, or in addition to, his or her firm or other employer): (1) receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report. See PCAOB Rule 1001(p)(i) for the definition of an associated person of a registered public accounting firm."). Therefore, the fact that Aronson was the sole member of his firm was not a defense to the resulting violations.

⁷ *In the Matter of David A. Aronson, CPA, P.A., and David A. Aronson, CPA*, PCAOB Release No. 105-2015-03, at ¶¶ 10-13.

⁸ *Id.*

⁹ *Id.* at ¶ 14.

¹⁰ *Id.*

¹¹ *Id.* at ¶¶ 15-21.

¹² *Id.* at ¶ 22.

¹³ *Id.* at ¶¶ 23-26.

¹⁴ *Id.* at ¶ 27.

issuer audit client despite not obtaining an engagement quality review.¹⁵

It appears that the PCAOB required admissions from Aronson given the number of times the DEI identified the firm's failure to comply with AS 7 and the number of times (ten) 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, Aronson admitted to violating Rule 2-01 of Regulation S-X ("Rule 2-01") on five of these audit engagements.¹⁶ 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 non-dependent child, from serving in an accounting role at an audit client during the period covered by the audit.¹⁷ Aronson's son owned a bookkeeping firm, which Aronson recommended to four of his issuer audit clients.¹⁸ 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.¹⁹ Each of these financial statements were then audited by Aronson.²⁰

Potential Implications of The DEI's New Admissions Policy

While it remains to be seen how often and under what circumstances the PCAOB will require audit firms or auditors settling enforcement actions to admit to the underlying facts, the factors Mr. Modesti announced and the facts of Aronson indicate that the PCAOB likely will look for admissions if violations are brought to the attention of an auditor, yet the auditor fails to take any steps to remedy the underlying issue.

The factors that the DEI will consider under its new admissions approach are similar to those used by the SEC. The SEC requires admissions in instances where there are parallel criminal convictions or non-prosecution 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

¹⁵ *Id.*

¹⁶ *Id.* at ¶¶ 30-32.

¹⁷ See PCAOB Rule 3520, Note 1, available at 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).

¹⁸ *In the Matter of David A. Aronson, CPA, P.A., and David A. Aronson, CPA*, PCAOB Release No. 105-2015-03, at ¶ 32.

¹⁹ *Id.*

²⁰ *Id.*

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

²² Dina ElBoghady, *SEC to Require Admissions of Guilt in Some Settlements*, The Washington Post (June 18, 2013),

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

In light of this similarity, 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 settlement with the PCAOB. The SEC required admissions in a dozen settlements between 2013 and 2014,²⁴ but settled the remaining actions using neither admit nor deny language. This pattern is consistent with Mr. Modesti's announcement, in which he noted that, "given that DEI must balance the public interest in getting wrongdoers out of the business of public auditing against the possibility of extended nonpublic disciplinary proceedings," 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."²⁵

It is worthwhile to note that, similar to the SEC, the DEI'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 PCAOB may require admissions in order to stress the importance of audit standard compliance in these engagements.²⁶ It also may be used to emphasize the importance of cooperating with and responding appropriately to the PCAOB inspection staff.

From the auditor's perspective, the considerations underlying whether to admit facts or violations as part of a settlement may be a particularly difficult one. For

available at http://www.washingtonpost.com/business/enforcement/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 Modesti, *Modification to Settlement Recommendations for Disciplinary Proceedings*, at n. 1, *supra*.

²⁶ 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; 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; 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.

example, admissions by accounting firms regarding alleged audit failures under PCAOB standards or SEC independence rules could be used against the auditor by audit clients or investors in follow-on litigation or in a parallel enforcement action brought by another agency. Consequently, how the admission is phrased and the conduct described in settlement orders containing admissions may be significant.

Conclusion

In his remarks, Mr. 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.”²⁷ Yet, in announcing the DEI’s new admissions policy, Mr. Modesti also made clear that the PCAOB will require admissions in settlements “where heightened accountability and acceptance of responsibility are in the public interest.”²⁸

²⁷ Modesti, *Modification to Settlement Recommendations for Disciplinary Proceedings*, at n. 1, *supra*.

²⁸ *Id.*