

## Recapping A Record Year For The PCAOB

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2016 was the busiest year ever for the Public Company Accounting Oversight Board's Division of Enforcement. The PCAOB made public a record 59 disciplinary proceedings, including 54 proceedings in which orders were reached through settled disciplinary orders and five through the adjudication process. This marks a significant increase from the 46 proceedings made public in 2015. With the growing number of PCAOB enforcement proceedings, it is more important than ever for accountants and their lawyers to remain aware of PCAOB enforcement priorities.

While the PCAOB is required by law to keep its enforcement proceedings confidential until a resolution is reached,[1] the proceedings made public in 2016 provide guidance regarding the PCAOB's current enforcement priorities. This article provides an overview of the disciplinary proceedings made public by the PCAOB in 2016 and identifies the types of violations on which the PCAOB focused and the sanctions it typically imposed.

Broadly, the main areas of focus for PCAOB enforcement in 2016 were on improper alterations of audit documentation in connection with PCAOB inspections and investigations, violations of auditor independence requirements, failures to maintain professional skepticism and support an audit's conclusions with sufficient evidence, violations of rules concerning performance of the engagement quality review of an audit, noncooperation with PCAOB investigations, and failures by firms registered with the PCAOB to file the required annual report and/or pay the annual fee. Highlights of these proceedings include:

- An \$8 million civil money penalty, the highest ever in a PCAOB enforcement proceeding, imposed on a Deloitte global network firm member in Brazil primarily based on allegations it improperly altered audit documentation and otherwise obstructed a PCAOB inspection and investigation into audits of two issuers.[2]
- A \$750,000 civil money penalty imposed on a Deloitte global network firm member in Mexico for alleged deficiencies in archiving audit documentation.[3]
- An adjudicated decision in which a former Ernst & Young partner raised constitutional challenges to the PCAOB's authority to issue sanctions.[4] The challenges were rejected by the U.S. Securities and Exchange Commission on appeal, but the respondent is appealing the decision in the U.S. Court of Appeals for the District of Columbia Circuit.[5]



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## **Overview of PCAOB Enforcement Proceedings Made Public in 2016**

Typically, in a settled disciplinary order, the respondent neither admits nor denies the order's factual findings, but consents to the entry of the order. The findings may be used solely for the purposes of the proceeding or any other proceeding brought by or on behalf of the PCAOB, or to which the PCAOB is a party. The findings are not binding on any other person or entity.

### ***Improper Alteration of Work Papers in Connection with a PCAOB Inspection or Investigation***

Auditing standard 1215 (formerly AS No. 3) states that audit documentation must be assembled by the "documentation completion date," which is 45 days after the release date of the report.[6] Audit documentation must not be deleted or discarded. Any documentation added must indicate the date the information was added, the name of the person who prepared it, and the reason for adding it.[7]

On April 21, 2016, the PCAOB released staff audit practice alert No. 14, titled "Improper Audit Documentation," which cautioned that improper alteration of audit documentation in connection with a PCAOB inspection can constitute a violation of PCAOB Rule 4006, Duty to Cooperate with Inspectors.[8] The alert emphasized that this type of misconduct undermines the integrity of the inspection process.

Indeed, the PCAOB made this issue a high enforcement priority in 2016, publicly disclosing 17 disciplinary proceedings involving allegations of improper alteration of audit documentation. Most of these proceedings were connected to two separate investigations of Deloitte global network firm members: Deloitte Touche Tohmatsu Auditores Independentes (Deloitte Brazil) and Galaz Yamazaki Ruiz Urquiza SC (Deloitte Mexico). Nearly all of the alleged violations involved attempts to conceal audit violations from PCAOB inspectors or investigators.

The proceedings against Deloitte Brazil originated from inspections into the firm's audits of two issuers in 2012. The PCAOB alleged that the staff at Deloitte Brazil, including senior partners who were entrusted with leadership roles, extensively altered audit documentation and presented the misleading documentation to inspectors as if it had been prepared at the time of the audit. The staff later presented the same misleading documentation to PCAOB investigators.[9]

In a settled order, Deloitte Brazil admitted that its staff had altered audit documentation and failed to cooperate with the inspection and investigation. The PCAOB censured Deloitte Brazil and imposed a civil money penalty of \$8 million on the firm. The penalty is the largest ever in a PCAOB enforcement proceeding. The order also required Deloitte Brazil to carry out certain undertakings, including adopting procedures designed to ensure that audit documentation is preserved and modified only in accordance with PCAOB standards, providing additional training to personnel, and enhancing reporting procedures for firm personnel to report misconduct anonymously. Deloitte Brazil must also retain an independent monitor to review its procedures and ensure they are adequate. The firm was prohibited from accepting engagements with new clients until it has submitted a certificate to the PCAOB that it has complied with the terms of the order.[10]

Several former employees of Deloitte Brazil were sanctioned for their roles in the alleged misconduct. These sanctions varied with the severity of the alleged misconduct and typically included censure and a bar from associating with a registered public accounting firm with the right to petition for reinstatement after a period of at least a year. Certain individuals were also assessed civil money penalties ranging from \$10,000 to \$20,000.[11] Notably, one individual received a reduced sanction for providing substantial

assistance and cooperation with the investigation.[12]

PCAOB Chairman James R. Doty praised Deloitte Brazil's response to the violations in testimony given at an SEC open meeting. He noted that none of the charged individuals are still with the firm and that the firm had taken other remedial measures. He stated, "That is real accountability that protected investors." [13]

The proceedings against Deloitte Mexico originated from a 2012 inspection into the firm's audits of an issuer. The PCAOB alleged that Deloitte Mexico repeatedly archived audit documentation late in connection with issuer audits and failed to implement policies and procedures to provide reasonable assurance that its engagement personnel were archiving audit documentation in compliance with the audit standards. Under the terms of the settled order, the PCAOB censured the firm, imposed a \$750,000 civil money penalty, and required the firm to undertake remedial measures to ensure compliance with rules regarding archiving audit documentation.[14]

The PCAOB also sanctioned three individuals in connection with this investigation.[15] One of the individuals, Arturo Vargas Arellano, was the engagement partner for the audits of the issuer from 2009 through 2012. According to the findings in the settled disciplinary order, Vargas failed to exercise due professional care and skepticism during the audit, and, as a result, failed to gather sufficient evidence and perform appropriate procedures to support many of the audit report's conclusions. In an attempt to conceal this misconduct during a post-audit practice review, Vargas and other members of the engagement team allegedly deleted audit documentation and made numerous alterations to existing documentation.

During a subsequent PCAOB inspection of the audit, Vargas allegedly made the improperly altered documentation available to PCAOB inspectors and represented that it had been prepared during the audit. He later presented the same misleading documentation to PCAOB investigators.[16] In a settled order, Vargas was censured, received an associational bar with the right to petition for reinstatement after five years, and was assessed a civil money penalty of \$50,000.[17] Two other individuals were sanctioned for their roles in the misconduct. One, a partner, was censured, received an associational bar with the right to petition for reinstatement after two years, and was assessed a civil money penalty of \$25,000.[18] The other, an audit senior, was merely censured.[19]

### ***Violations of Auditor Independence Requirements***

The SEC and PCAOB rules require that auditors be independent from the companies they audit in order to ensure that they remain objective and work on behalf of investors and the public interest, rather than on behalf of the client. In practice, this means that auditors may not perform any nonaudit services for the audit client contemporaneously with the audit, including the preparation of financial statements, bookkeeping, or services relating to the client's accounting records.[20]

One of the animating concerns behind the independence requirement is that it is inconsistent for an auditor to attempt to play two roles — "one as a supposed objective third party examining management's assertions and another as management's consultant, partner or advocate." [21] Another concern is the principle that an auditor should not audit his own work.[22]

In 2016, the PCAOB made public 16 proceedings involving auditor independence, nine of which involved broker-dealer clients and seven of which involved issuer clients. Typically, proceedings involved audit firms that prepared financial statements or accounting records for a client and, as a result, were not

independent of the client at the time they performed the audit. Sanctions applied to firms were most commonly (1) censure, (2) a civil money penalty of \$2,500 or higher, depending on the severity of the violation, and (3) the requirement that the firm undertake certain remedial measures designed to ensure the firm satisfies independence criteria in the future.

The PCAOB has imposed harsher sanctions when the conduct is alleged to be reckless. For example, in one proceeding a firm allegedly had performed an audit for a client despite having maintained and prepared accounting records and financial statements for the year of the audit. The PCAOB specifically communicated to this firm that the conduct impaired its independence. Nonetheless, according to the findings of the settled disciplinary order, the firm engaged in substantially the same conduct the following year. The PCAOB censured the firm and its lead partner. It also prohibited the firm from accepting any new broker-dealer engagement clients for one year, required it to undertake remedial measures, and imposed a civil money penalty on the firm of \$15,000. The partner was sanctioned with an associational bar, with the right to petition for reinstatement after one year, and a civil money penalty of \$5,000.[23]

The largest civil money penalty in a proceeding involving auditor independence was assessed against Deloitte Accountants BV (Deloitte Netherlands). The findings of the settled disciplinary order state that Deloitte Netherlands violated independence rules in audits of two issuer clients due to financial interests that the firm's CEO's spouse held in these two issuers. The PCAOB censured Deloitte Netherlands and assessed it with a civil money penalty of \$300,000.[24]

### ***Failures to Maintain Professional Skepticism***

PCAOB standards require auditors to obtain sufficient evidence to form conclusions concerning the validity of assertions in the client's financial statements and to evaluate the evidence with due professional skepticism, rather than accept the assertions of the client at face value.[25] In 2016, the PCAOB made public 15 disciplinary proceedings involving failures to exercise professional skepticism. Sanctions against firms typically consisted of censure and the revocation of the firm's registration with the right to reapply after one or more years. Individuals were typically censured and barred from association with the right to apply for reinstatement after one or more years. Civil money penalties were imposed on both firms and individuals in cases with particularly reckless conduct.

One of the proceedings involved an Ernst & Young partner, Mark Laccetti, who was the engagement partner for an audit of the 2004 financial statements of Taro USA, a subsidiary of an Israel-based pharmaceutical company. The parent company later restated its financial statements for 2004 due to the subsidiary's erroneously low chargeback estimates, which caused multimillion dollar overstatements of net sales and accounts receivable. In the adjudicated final decision, the PCAOB found that Laccetti had failed to perform necessary analysis of the chargeback estimates to address the deficiency. The PCAOB sanctioned Laccetti with an associational bar, granting him the right to petition for reinstatement after two years, and an \$85,000 civil money penalty.[26]

Laccetti appealed the sanctions before the SEC on constitutional and procedural grounds. The constitutional challenge was based on the case *Free Enterprise Fund v. PCAOB*, 561 U.S. 477 (2010), in which the U.S. Supreme Court struck down Sarbanes-Oxley's provisions restricting the removal of PCAOB board members by the SEC as unconstitutional because these restrictions improperly shielded board members from executive oversight. Laccetti argued that *Free Enterprise* mandated dismissal of the proceedings against him because the PCAOB's structure was in violation of the constitution at the time it investigated and initiated proceedings against him. The SEC rejected this challenge, stating that the constitutional violations had been remedied and that the PCAOB was subject to the necessary executive

oversight at the time of Laccetti's hearing. The SEC also rejected Laccetti's argument that he was denied the right to counsel when the PCAOB refused to permit an accountant employed by Ernst & Young to sit in on his investigative testimony as an expert consultant. The SEC stated that Laccetti had no right to an expert consultant at his investigative testimony, and that any conceivable error was not prejudicial because this testimony was not a basis for the PCAOB's final decision.[27] Laccetti is appealing the SEC decision to the U.S. Court of Appeals for the D.C. Circuit.

### ***Violations of AS7 (Engagement Quality Review) (Currently AS 1220)***

Auditors are required to perform an "engagement quality review" (EQR) and obtain a concurring approval from the reviewer prior to issuance of an audit. The purpose of this review is to perform an evaluation of the significant judgments and conclusions made by the engagement team prior to the audit's release. The EQR must be performed by a partner or someone of an equivalent position. In order to maintain objectivity, the reviewer must not make decisions or assume any responsibility on behalf of the engagement team.[28]

In 2016, the PCAOB made public 12 disciplinary proceedings involving violations of rules concerning the EQR. Violations broke down into the following categories: (1) the reviewer failed to adequately evaluate the engagement team's significant judgments; (2) the reviewer was not objective because he worked on the engagement team in addition to performing the EQR; (3) the reviewer was not independent of the client being audited; (4) the EQR was not performed by a partner or someone of an equivalent position; and (5) the auditors failed to perform any EQR whatsoever.

Sanctions for the alleged violations of EQR rules varied widely based on the severity of the misconduct. For example, when the PCAOB found that a firm assigned a manager, rather than a partner or someone of an equivalent position, to perform EQRs for audits of two issuers, the firm was censured, assessed a civil money penalty of \$2,500, and required to take remedial measures to prevent further violations. The head of the assurance practice at the firm was also censured.[29] On the more severe end of the spectrum, when the PCAOB found that a firm failed to perform any EQRs whatsoever on 24 audits over a one-and-a-half year period, the registration of the firm was permanently revoked and the engagement partner responsible for the audits was sanctioned with a permanent associational bar.[30]

### ***Noncooperation With a PCAOB Investigation***

During investigations the PCAOB often issues "accounting board demands" (ABDs) requiring that a firm or individual provide documents or testimony. Failure to comply with an ABD is grounds for disciplinary proceedings.[31] In 2016, the PCAOB made public nine proceedings involving noncooperation with an investigation due to failure to comply with an ABD.

One proceeding arose when the PCAOB issued an ABD to a Hong Kong firm requiring it to provide testimony in connection with an investigation into an audit of the financial statements of a China-based issuer. According to the findings of the settled disciplinary order, the firm refused to provide testimony and contended that the PCAOB was required to make a request for assistance under a May 2013 memorandum of understanding (MOU) between the PCAOB and Chinese regulatory authorities. The PCAOB disagreed, asserting that the MOU did not supersede the domestic laws of the parties and was not a valid justification for refusing to provide the testimony. The PCAOB censured the firm and revoked its registration with the right to reapply for registration after three years.[32] Three individuals were also sanctioned in connection with the alleged noncooperation. They each received identical sanctions of censure plus an associational bar with the right to apply for reinstatement after three years.[33]

In another proceeding, the PCAOB permanently revoked the registration of a New Jersey firm after finding that it failed to produce documents related to audits of the financial statements of three issuers.[34] Three individuals were also sanctioned in connection with the noncooperation, two of whom received permanent associational bars.[35] The remaining respondent also received an associational bar, but was granted the right to petition for reinstatement after five years. This respondent likely received a lesser sanction because she held a lower-ranking position at the firm.

### ***Failure to File Annual Report/Pay Annual Fees***

Each registered public accounting firm must file an annual report with the PCAOB and pay an annual fee.[36] Failure to do so timely can result in disciplinary sanctions. The PCAOB made public six disciplinary proceedings involving failures to timely file annual reports and/or pay annual fees. Sanctions varied with the severity of the misconduct. In one case, a firm that did not timely pay its annual fees for 2013 and 2014 or timely file an annual report for 2014 was censured, had its registration suspended for one year, and was assessed a civil money penalty of \$1,000.[37] In a more egregious case, a firm that had failed to file the required annual reports or to pay annual fees for three years was censured, had its registration permanently revoked, and was assessed a civil money penalty of \$10,000.[38]

### **Looking Forward**

The types of proceedings made public by the PCAOB in 2016 are likely to remain staples of its enforcement agenda for the foreseeable future. PCAOB board member Steven B. Harris cautioned in a June 28 speech that the issue of auditor independence will remain an enforcement priority as accounting firms increasingly move into consulting and advisory services.[39] Additionally, in a Dec. 7 speech, Claudius Modesti, PCAOB director of enforcement, emphasized that lack of professional skepticism, matters related to the independence and integrity of the audit, and matters threatening the integrity of the PCAOB's regulatory oversight process are high-priority enforcement areas.[40]

Modesti also emphasized that risks associated with cross-border audits are another major concern for the PCAOB and that the PCAOB is actively looking to increase enforcement against international affiliates involved in the audits of U.S. listed companies. He stated that these matters pose increased audit risks due to differing corporate governance practices and business norms. The recent enforcement proceeding and \$1 million civil money penalty against Ernst & Young Indonesia demonstrates that ensuring compliance with PCAOB standards internationally must be a top priority for firms with global networks.[41]

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[1] Section 105(c)(2) of Sarbanes-Oxley; PCAOB Rule 5203.

[2] See *In the Matter of Deloitte Touche Tohmatsu Auditores Independentes*, PCAOB Release No. 105-2016-031 (Dec. 5, 2016).

[3] See In the Matter of Galaz Yamazaki Ruiz Urquiza SC, PCAOB Release No. 105-2016-044 (Dec. 5, 2016).

[4] See In the Matter of Mark E. Laccetti, CPA, PCAOB File No. 105-2009-007 (Jan. 26, 2015).

[5] In the Matter of the Application of Mark E. Laccetti, CPA, SEC Release No. 78764 (Sep. 2, 2016); 16-1368 (D.C. Cir. 2016).

[6] AS 1215: Audit Documentation, ¶ 15.

[7] Id. at ¶ 16.

[8] See PCAOB Staff Audit Practice Alert No. 14: Improper Alteration of Audit Documentation (Apr. 21, 2016).

[9] PCAOB Release No. 105-2016-031.

[10] Id.

[11] See e.g. In the Matter of Marco Aurelio Aulino Neves, PCAOB Release No. 105-2016-041 (Dec. 5, 2016); In the Matter of Joao Rafael Belo de Araujo Filho, PCAOB Release No. 105-2016-037 (Dec. 5, 2016).

[12] In the Matter of André Ricardo Aguilar Paulon, PCAOB Release No. 105-2016-035 (Dec. 5, 2016).

[13] James R. Doty, PCAOB chairman, Testimony on the PCAOB 2017 Budget and Strategic Plan, SEC Open Meeting on the PCAOB Budget (Dec. 14, 2016).

[14] PCAOB Release No. 105-2016-044.

[15] See In the Matter of Arturo Vargas Arellano, CPC, PCAOB Release No. 105-2016-045 (Dec. 5, 2016); In the Matter of Miguel Angel Asencio Asencio, PCAOB Release No. 105-2016-046 (Dec. 5, 2016); [15] In the Matter of Aldo Hidalgo de la Rosa, PCAOB Release No. 105-2016-047 (Dec. 5, 2016).

[16] PCAOB Release No. 105-2016-045.

[17] Id.

[18] PCAOB Release No. 105-2016-046.

[19] PCAOB Release No. 105-2016-047.

[20] Securities Exchange Act of 1934, § 10A(g); Exchange Act Rule 10A-2.

[21] Steven B. Harris, PCAOB board member, Auditor Independence and the Role of the PCAOB in Investor Protection, International Corporate Governance Network Annual Conference (June 28, 2016).

[22] SEC Press Release 2014-272, SEC Sanctions Eight Audit Firms for Violating Auditor Independence Rules (Dec. 8, 2014).

[23] In the Matter of Berkow Schechter & Co. LLP and Neil H. Berkow, CPA, PCAOB Release No. 105-2016-028 (Sep. 15, 2016).

[24] In the Matter of Deloitte Accountants BV, PCAOB Release No. 105-2016-051 (Dec. 13, 2016).

[25] See e.g. AS 1015: Due Professional Care in the Performance of Work.

[26] PCAOB File No. 105-2009-007.

[27] SEC Release No. 78764.

[28] AS 1220: Engagement Quality Review.

[29] In the Matter of Maillie LLP and Laurie Harvey, CPA, PCAOB Release No. 105-2016-021 (June 14, 2016).

[30] In the Matter of David Lee Hillary Jr. and David Lee Hillary Jr., CPA, PCAOB Release No. 105-2016-049 (Dec. 13, 2016).

[31] PCAOB Rule 5300(b).

[32] In the Matter of PKF [Hong Kong], PCAOB Release No. 105-2016-001 (Jan. 12, 2016).

[33] In the Matter of Edith LAM Kar Bo, PCAOB Release No. 105-2016-002 (Jan. 12, 2016); In the Matter of Derek WAN Tak Shing, PCAOB Release No. 105-2016-003 (Jan. 12, 2016); In the Matter of Kim Wilfred Ti, PCAOB Release No. 105-2016-004 (Jan. 12, 2016).

[34] In the Matter of Li and Co. PC, PCAOB Release No. 105-2016-022 (June 14, 2016).

[35] In the Matter of Tony Zhicong Li, CPA, PCAOB Release No. 105-2016-023 (June 14, 2016); In the Matter of Gary L. Singer, CPA, PCAOB Release No. 105-2016-024 (June 14, 2016); In the Matter of Chunmin Liu, CPA, PCAOB Release No. 105-2016-025 (June 14, 2016).

[36] PCAOB Rules 2200-2202.

[37] In the Matter of Kantor Akuntan Publik Jimmy Budhi, PCAOB Release no. 105-2016-005 (Jan. 21, 2016).

[38] In the Matter of David W. Dube, PCAOB File No. 105-2014-005 (Jan. 12, 2016).

[39] Harris, Auditor Independence and the Role of the PCAOB in Investor Protection.

[40] Claudius B. Modesti, director of enforcement, Protecting Investors Through Enforcement, AICPA Conference on SEC and PCAOB Developments (Dec. 7, 2016).

[41] In the Matter of KAP Purwantono Sungkoro & Surja, Roy Iman Wirahardha and James Randall Leali, PCAOB Release No. 105-2017-002 (Feb. 9, 2017).