

PCAOB ENFORCEMENT: THE NUCLEAR OPTION FOR SMALL & MID-SIZED FIRMS

APRIL 20, 2010



Agenda

- Introduction
- Presentation
 - Michael MacPhail, Partner, Holme Roberts & Owen LLP
 - Brent Baker, Shareholder, Parsons Behle & Latimer
- Questions and Answers — (*anonymous*)
- Slides — now available on front page of Securities Docket
 - www.securitiesdocket.com
- Wrap-up



Webcast Series

- Series of webcasts — every other week
- www.securitiesdocket.com/webcasts
- Next:
 - **April 27:** Math for Lawyers—Valuation Theory and Practice 101



Panel



Michael MacPhail



Brent Baker



Bruce Carton



PCAOB Inspections and Investigations: The Nuclear Option for Small and Mid-Sized Firms

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Introduction and Overview

- Regulatory Framework
- Status of Legal Challenge
- Inspections
 - ❖ Frequency and Audit Selection Criteria
 - ❖ Application of Standards: One Size Fits All
 - ❖ Reports – Public and Nonpublic
 - ❖ Remediation Efforts
- Enforcement Investigations
 - ❖ Document Requests, Testimony and Wells Process
 - ❖ Economic Burden Imposed on Firms and Clients



Regulatory Framework

- Legal Origin and Nature of PCAOB
- Budget Figures
- Who Must Register
 - ❖ Auditors of Reporting Companies
 - ❖ Broker-Dealer Auditors (not subject to regulation)
- Association of Individuals Performing Audits
- Legal Challenge





Inspections

- Frequency
- Selection Criteria
- “One-Size Fits All”
Application of
Standards
 - ❖ Fees May Not
Support Necessary
Procedures
 - ❖ Standards are
Complex and
Subjective





Inspections (Continued)

- Audit Deficiencies
 - ❖ Burden of Proof
- Reports
 - ❖ Public and Nonpublic
 - ❖ Identification of Egregious Deficiencies
- Remediation Efforts
- Possible Use of Outside Counsel



Enforcement Investigations: Characteristics

- Origin and Purpose
- Formal Orders – Define Scope
- Document Production - ABDs
 - ❖ “E-Discovery” issues
 - ❖ Attestations
 - ❖ Follow-Up requests
 - ❖ Distracts from Business Operations



Enforcement Investigations: Testimony

- ❖ Duration and Location
- ❖ Staff Will Not Pay Counsel's Travel Costs
- ❖ Aggressive Behavior
 - Use of Leading Questions
- ❖ Due Process Concerns
- ❖ Rules of Evidence Don't Apply
- ❖ No Judicial Oversight





Enforcement Investigations (Cont.)

- “Wells” Process
 - ❖ Importance
 - ❖ Poorly Defined by Rules
- High Defense Costs = Nuclear Option!
 - ❖ Voluminous Document Production and E-Discovery Obligations
 - ❖ Testimony Preparation and Defense
 - ❖ Complex Factual Issues and Professional Standards
- Need Competent Counsel and Insurance Coverage



PCAOB Enforcement: The Nuclear Option for Small and Mid-Sized Firms

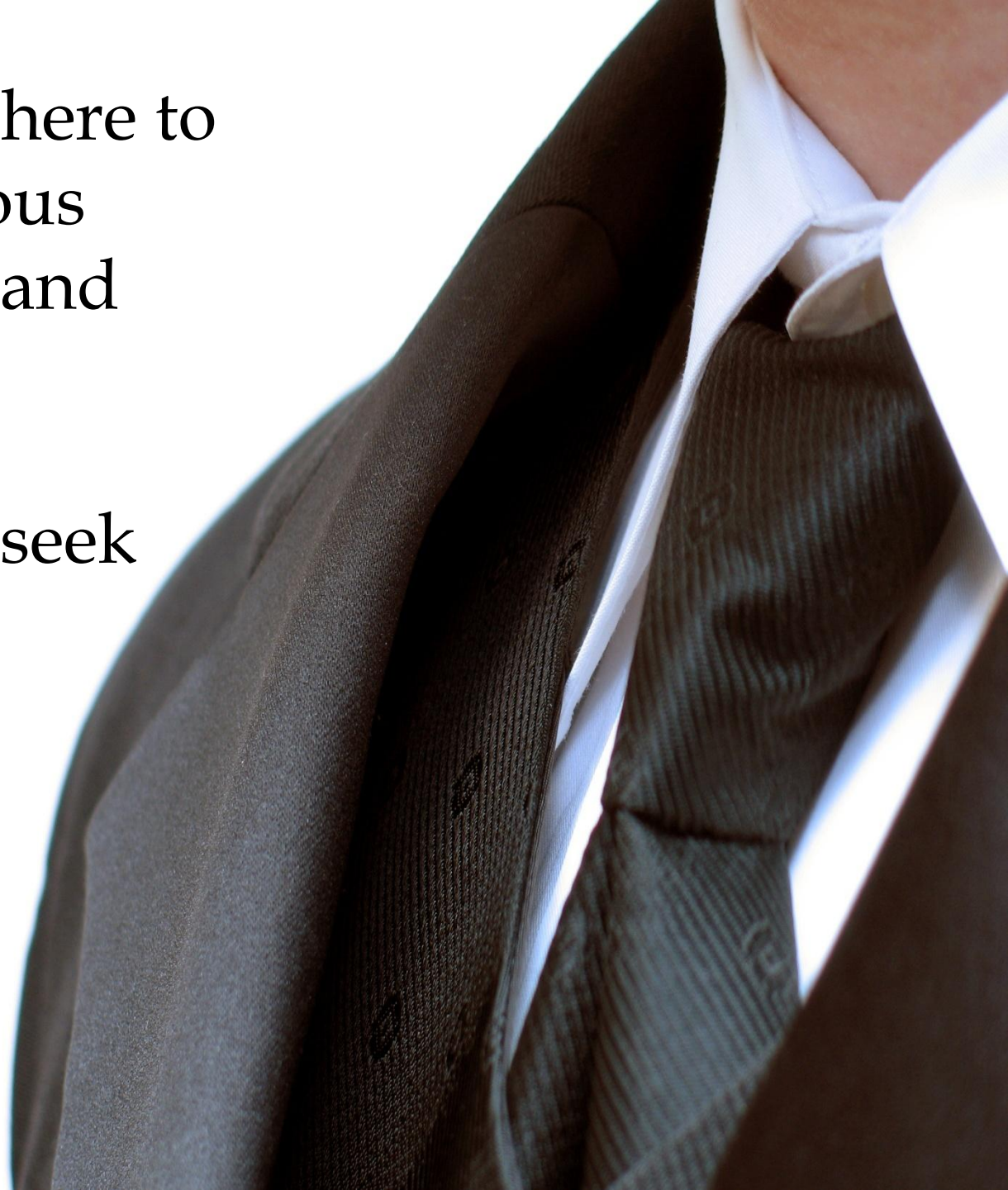
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- They are NOT here to help. Be cautious before, during and after PCAOB examination. Cooperate but seek legal counsel.



Problems with PCAOB

Internal Ethos

- Constant reference to fulfilling its “mission.” What is its mission?
- “The mission of the PCAOB is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.”

Contrast with.....

- No significant increase in private civil claims against small accounting firms according to research.



Inherent Unfairness in PCAOB Administrative Proceedings

PCAOB conduct
during litigation
is very
aggressive.
Unequal
distribution of
power.



LITIGATION ISSUES

- Administrative Proceedings
- No Federal Rules of Evidence
- PCAOB routinely try to invoke Federal Rules of Evidence to your client's detriment
- Difficult if not impossible to subpoena witnesses for hearing. Must request authority from ALJ. **No real discovery.**

Nature of Proceedings

- PCAOB only has administrative proceedings.
- PCAOB enforces laws and rules within the Board's jurisdiction – PCAOB Rules (including auditing and ethics standards), Reg. S-X, and 10A (PCAOB Rule 5100(a)).



Is Rule 5110 Non-cooperation being used improperly?

The “Non-cooperation” safety net



Attorney Client Privilege Concerns

- Privilege Issues
- Common Interest Privilege when representing CPA and Firm.
- Selective Waiver and Disclosure of Internal Investigation Reports
- SEC v. Collins & Aikman



Implications for Accountants and Clients

- Regulatory risk for issuers.
- Big difference between “business as usual” change in auditors disclosure and disclosure regarding “non-reliance on previously issued financial statements.”
- Taint from PCAOB proceeding can spill over to issuers.

Moore & Associates Administrative Proceeding is a good Study

- Moore had not been auditing public companies 10 years prior to registration with the PCAOB.
- Over the next three years, M&A accepted nearly 300 public audit engagements, with Moore serving as the auditor with final responsibility on each of them.
- M&A audit staff was comprised of inexperienced staff members overseen by one professional.
- M&A violated PCAOB quality control standards. In certain audits examined during inspection, M&A (1) failed to perform audit work for critical aspects of the audits, (2) violated Rule 10b-5 by issuing audit reports that represented that the audits had been conducted in accordance with PCAOB standards, (when they knew, or were reckless in not knowing, that such representations were false).
- Moore and M&A failed to cooperate with the PCAOB's investigation in three ways: (1) they created false work papers that did not accurately reflect the work performed on the relevant audits; (2) Moore falsely testified that these work papers were true and accurate audit work; and 3) M&A failed to produce documents required by an Accounting Board Demand.



PCAOB Often Forces a Fight on Multiple Fronts

- PCAOB knows how to inflict serious injury when the facts it discovers don't allow it to go forward under its own Rules.
- Watch out for frequent and early tips to State Accountancy Boards. One case where tip to a small county attorney resulted in criminal charges.

Insurance Issues

- Does PCAOB investigation = a claim sufficient to trigger payment of defense costs?
- MBIA, Inc. v. Federal Ins. Co. and Am. Ins. Co. (No. 08 CIV 4313, slip op. (S.D.N.Y. Dec. 30, 2009) defines “claim” broadly to include responding to administrative subpoenas etc.
- Center for Blood Research, Inc. v. Coregis Ins. Co., 305 F. 3d 38 (1st Cir. 2002) states that investigative subpoena does not trigger a “claim.” Trend towards broadening definition in securities context.

- Compounded by fact that PCAOB Rule 5109(d) does not require PCAOB to provide written notice as Mike has explained.
- ABA position on PCAOB Rules of Practice and Wells Committee legislative history all support the conclusion that the **process** is not **fair**. Even the SEC's process is much fairer.

PCAOB is exempt from FOIA. (Section 105(b)(5)(A) & PCAOB Rule 5108)



End Result/Outcome

- Suspension or permanent bar. (PCAOB Rules 5300(a)(1) & (2))
- Limitations on activities. (PCAOB Rule 5300(a)(3))
- Civil Monetary Penalties.
- Censures, additional education or other sanctions per Board rules. (PCAOB Rules 5300(a)(5), (6) & (8) – (10))



How to craft language of Settlement or Sanction

- Look at State Accountancy Board Statutes to determine what will trigger disciplinary proceedings.
- Always expect a referral by PCAOB
- Renewals or initial application require disclosure of Wells/PCAOB investigations
- Tager footnote? Successful in using in SEC OIP context – seems it would have similar weight with the PCAOB

What's on the Horizon?

- In the Middle of Credit Crisis fallout Cases
- Seems like this regulator is not aware that its overseer publicly states that it should not seek enforcement of “Mistakes.”
- SEC and PCAOB Personnel Changes/budget increases.
- SEC Realignment and Coordination Between the Two
- Anything the tarnishes SEC spills over on to PCAOB – IG Reports are alarming.

CONTACT INFORMATION FOR PRESENTER

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Q & A



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Questions?



Thank You

Thank you for attending this webcast.

