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Focus

What Public Companies Should Know Before the PCAOB Calls

BY RUSSELL G. RYAN

On August 26, 2004, the Public Company Accounting Oversight Board issued reports on its first round of "limited" inspections of the Big Four accounting firms.¹ Although the inspection reports are of primary interest to accounting firms that audit public companies, they also provide a timely reminder to public companies that the PCAOB's regulatory, inspection, and enforcement activities can directly affect them too.

Background

The PCAOB is a private, non-profit corporation created by the Sarbanes-Oxley Act of 2002 to regulate the accounting firms that audit public company financial statements.² One of the board's primary functions, highlighted by its recently issued reports, is to conduct annual inspections of the biggest audit firms and inspections of smaller audit firms at least once every three years.³ The board's other primary functions include the registration of all accounting firms that audit public companies, the establishment of audit standards, and the investigation and discipline of auditors and firms that violate the board's rules or applicable securities laws.⁴ All of the board's activities are subject to oversight by the Securities and Exchange Commission.⁵

The work of the PCAOB will undoubtedly affect public companies in a number of important but indirect ways. For example, in establishing standards for the conduct of audits, including auditor independence standards, the board will certainly change the manner in which auditors perform some of their field work, the extent to which they rely on company management in evaluating corporate

internal controls, and the types of non-audit services they can perform for the company. Moreover, the board's inspections of registered audit firms will occasionally find accounting errors that require a restatement of the audit client's financial statements. In this regard, the board's recently issued inspection reports together indicate that at least 20 public companies were required to file restated financials as a direct result of the board's first round of limited inspections of audit firms.

Thus far, most public companies have had only minimal *direct* exposure to the PCAOB, mostly in the form of paying the "accounting support fees" that fund the board's annual operating budget, which is just over \$100 million for 2004.⁶ The board invoices each public company that has a market capitalization above \$25 million (and certain investment companies) based on market capitalization relative to the overall market. Of the approximately 8,800 public companies invoiced in 2003, the largest 100 companies paid nearly half of the total fees collected, with a small handful paying a fee of more than \$1 million each. At the other end, about half the companies paid less than \$500 each.⁷

Inevitably, many public companies will be getting more than a fee invoice from the PCAOB in the foreseeable future. Although the board's jurisdiction and coercive powers are technically limited to the accounting firms that are registered with it, the board has made clear that it will be seeking information directly from public companies in the course of its inspections, investigations, and disciplinary proceedings involving registered audit firms. Thus, it is important for public companies to understand the ways in which they may soon encounter this relatively unknown regulator, as well as their

rights and obligations in the event of such an encounter.

PCAOB Inspections of Audit Firms

Sarbanes-Oxley requires the PCAOB, in conducting its periodic inspections of registered audit firms, to "inspect and review selected audit and review engagements."⁸ It is by now quite clear that the PCAOB inspection staff will routinely request an interview, on a voluntary basis and typically over the telephone, of the audit committee chair of each company whose audit engagement is among those selected for review. Indeed, in its recently-released inspection reports, the board stated that its staff interviewed the audit chairs of virtually all of the companies whose audits were selected for review.⁹ This revelation is consistent with comments made by board member Daniel Goelzer during a February 2004 speech before the Glasser Legal-Works' 22nd Annual Institute on Federal Securities:

"[I]n light of the enhanced role that Sarbanes-Oxley carves out for audit committees, board inspections will examine the relationship between the auditor and the audit committee. In fact, as part of the review of specific engagements that was a component of the 2003 limited inspection program, the inspections teams interviewed audit committee chairs. The objective of these interviews, usually conducted by telephone, was to assess the quality of the accounting firm's relationship and communications with the audit committee. The board can't compel an audit committee member to speak with the inspection staff, but none of the 50 or so audit committee chairs contacted refused. In fact, many expressed support for the board and its work."¹⁰

¹ These reports, along with the PCAOB's "Statement Concerning the Issuance of Inspection Reports," are available on the PCAOB Web site at <http://www.pcaobus.org/Inspections>.

² See Sarbanes-Oxley §§ 101-109.

³ See *id.* § 104.

⁴ See *id.* §§ 102, 103, and 105.

⁵ See *id.* § 107.

⁶ PCAOB Budget for Fiscal Year 2004 (available at http://www.pcaobus.org/2004_Budget_Presentation.pdf).

⁷ PCAOB 2003 Annual Report (available at http://www.pcaobus.org/documents/PCAOB_2003_AR.pdf).

⁸ Sarbanes-Oxley § 104(d)(1).

⁹ See PCAOB Report on 2003 Limited Inspection of Deloitte & Touche LLP at 3; *Id.* Ernst & Young LLP at 3; *Id.* KPMG LLP at 3; *Id.* PricewaterhouseCoopers LLP at 3.

¹⁰ Daniel L. Goelzer, "The PCAOB—One Year Later," Feb. 11, 2004 (text of

Information provided during such interviews, like all other evidence received by the PCAOB during its inspections and enforcement investigations, is protected by Sarbanes-Oxley with an unusually high degree of confidentiality going beyond even the “non-public” treatment accorded in a typical SEC investigation. Thus, unless and until the board discloses the contents of such an interview in connection with a public proceeding or disciplinary hearing, the interview “shall not be subject to civil discovery or other legal process” and is exempt from disclosure under the Freedom of Information Act.¹¹

Moreover, as acknowledged by board member Goelzer in his above-quoted speech, neither the board nor its staff can *require* any audit committee chair to submit to an interview. Because such interviews are entirely voluntary, audit committee chairs may decline the interview request altogether, answer only some of the particular questions, terminate the interview at any point, seek the advice of counsel before the interview, and insist that counsel be present during the interview.

However, while consultation with counsel is always well advised, outright refusal to grant a voluntary interview—or even declining to answer selected questions—is likely to raise the suspicion and ire of the PCAOB staff, which could easily result in an unwanted referral of the matter to either the board’s own enforcement staff or to the SEC.¹² As discussed below, such a referral runs the associated risk, among many others, that the audit committee chair and other company representatives will eventually be compelled by subpoena to testify under oath in an enforcement investigation.

Investigations, Other Proceedings

Sarbanes-Oxley authorized the PCAOB—in addition to registering audit firms, setting standards, and inspecting registered firms—to investigate and discipline registered accounting firms and their “associated persons.”¹³ In such proceedings, registered firms and “associated per-

sons” are required to comply with demands by the board and its staff to testify and produce documents.¹⁴ Although audit clients are not among the “associated persons” required to comply with board demands, the PCAOB and its staff have two ways of seeking information directly from such audit clients in the course of enforcement investigations and disciplinary proceedings.

First, the board or its staff can request the audit client to testify or produce documents voluntarily.¹⁵ As with inspection staff requests for voluntary interviews of audit chairs, the board cannot compel an audit client to comply. However, as a second option, the board can—apparently either in lieu of a voluntary request or in response to a rebuffed request—ask the SEC to issue a subpoena that would require the client to testify or produce documents.¹⁶

In practice, the PCAOB enforcement staff is likely to seek information from public company representatives on a voluntary basis in the first instance, unless either the SEC is already conducting a parallel investigation of the same matter or a request for voluntary cooperation appears futile. Although the board and the SEC are likely to develop a protocol designed to streamline requests for subpoenas, the process will inevitably require some level of formal paperwork by the staff of both organizations, causing a diversion of PCAOB resources along with a delay of its proceedings. The PCAOB staff may also be reluctant to invoke a procedure that could arouse the SEC staff’s interest in opening its own parallel investigation of the same matter, thereby further complicating and potentially overshadowing the board’s ongoing proceeding.

From the perspective of the party from whom the PCAOB staff is seeking information, cooperating with a voluntary request for testimony or documents will be advisable in many cases. First, before a subpoena is sought or issued, the party will have substantially more leverage in negotiating the timing, logistics, and scope of its testimony or document production. Second, as previously noted, evidence voluntarily provided to the PCAOB is protected by an express

statutory shield from civil discovery and other legal process, a shield that does not expressly extend to evidence produced pursuant to an SEC subpoena issued at the board’s request. Finally, a recalcitrant party that forces the PCAOB staff to seek an SEC subpoena runs a substantial risk of convincing the SEC and its staff not only to issue the subpoena, but also to open its own investigation.

Keeping Things ‘Civil’

Whether a public company provides information to the PCAOB on a voluntary basis or pursuant to an SEC subpoena issued at the request of the board, the company and its representatives must ensure that they do not mislead the PCAOB staff, alter or destroy documents, or otherwise obstruct the proceeding in any way. At a minimum, such conduct is likely to increase regulators’ suspicions, damage the company’s credibility, and make it more likely that the matter will eventually be referred to the SEC. More importantly, such conduct can transform an otherwise manageable civil investigation into a devastating criminal proceeding.

Of course, if a company representative gives testimony to the PCAOB staff under oath—whether voluntarily or pursuant to an SEC subpoena—false or misleading answers could lead to criminal perjury charges.¹⁷ On the other hand, because the PCAOB is not an agency of government, informal interviews and unsworn testimony in board proceedings generally should not expose a witness to criminal false statements charges under 18 U.S.C. § 1001. However, Section 1001 could apply if the SEC has become involved in a PCAOB proceeding through issuance of a subpoena or otherwise.

Even where the SEC has not yet visibly surfaced, obstructionist conduct could still lead to criminal prosecution. Sections 802 and 1102 of Sarbanes-Oxley amended federal obstruction law by, among other things, criminalizing the alteration, destruction, or concealment of documents with intent to “impede, obstruct, or influence” a government investigation or “matter,” or with intent to

speech available at http://www.pcaobus.org/transcripts/Goelzer_02-11-04.asp).

¹¹ Sarbanes-Oxley § 105(b)(5)(A).

¹² See Sarbanes-Oxley § 104(c) and PCAOB Rule 4004.

¹³ See Sarbanes-Oxley § 105.

¹⁴ See *id.* § 105(b)(2)–(3); PCAOB Rules 5102, 5103, and 5424(a).

¹⁵ See Sarbanes-Oxley § 105(b)(2)(C); PCAOB Rules 5105 and 5424(a).

¹⁶ See Sarbanes-Oxley § 105(b)(2)(D); PCAOB Rule 5424(b).

¹⁷ See 18 U.S.C. § 1621; *cf.* *People v. Cohen*, 773 N.Y.S.2d 371, 2004 N.Y. App. Div. LEXIS 2579 (2004) (sustaining perjury conviction under New York state law for false testimony during NASD investigation).

“impair the object’s integrity or availability for use in an official proceeding.”¹⁸ These provisions apparently can apply even if the actor is not aware of any particular government investigation, and indeed even if an investigation has not yet been commenced.¹⁹

Several recent cases further suggest that, even without these new provisions, criminal prosecution could result from misleading PCAOB investigators, altering or destroying documents, or otherwise impeding a PCAOB investigation anytime an SEC investigation is reasonably foreseeable. For example, accounting firm Arthur Andersen was convicted of obstruction for, among other things, encouraging continued compliance with its document deletion practices after the firm learned sufficient facts about Enron to conclude, in the words of the prosecutor, “that the SEC was coming.”²⁰

Likewise, former officers of both Computer Associates and Rite Aid have been charged with obstruction-related crimes for, among other things, misleading private lawyers who were conducting internal investigations on behalf of companies that had committed to share the results of those investigations with the government.²¹ Given the aggressive approach of prosecutors in these cases, and the new obstruction provisions of Sarbanes-Oxley, it is not difficult to imagine that prosecutors will impute awareness that “the SEC [is] coming” to witnesses involved in many PCAOB investigations.

¹⁸ Sarbanes-Oxley §§ 802 and 1102 (codified in relevant part at 18 U.S.C. §§ 1519 and 1512(c)).

¹⁹ See Gary G. Grindler and Jason A. Jones, *Please Step Away from the Shredder and the “Delete”* Key: §§ 802 and 1102 of the Sarbanes-Oxley Act, 41 AM. CR. L. REV. 67, 78–81 (2003).

²⁰ United States v. Arthur Andersen, LLP, 374 F.3d 281, 299 (5th Cir. 2004).

²¹ See United States v. Grass, Cr. 02-146 (M.D. Pa.) (indictment available at <http://www.usdoj.gov/dag/cftf/chargingdocs/grassetalind.pdf>); United States v. Zar, Cr. 04-331 (E.D.N.Y.); United States v. Silverstein, Cr. 04-0024 (E.D.N.Y.); United States v. Rivard, No. 04-329 (E.D.N.Y.); United States v. Kaplan, No. 04-330 (E.D.N.Y.).

PCAOB Referrals to SEC

The PCAOB can impose severe penalties and other sanctions against registered audit firms and their associated persons, both for substantive violations and for simply failing to comply with demands for information during board investigations.²² The board has no such power to penalize or sanction public companies, regardless of whether the company voluntarily cooperates with an inspection or investigation.

However, the board does have the ability to refer potential securities law violations by public companies (or anyone else) to the SEC for possible civil enforcement action and, at the direction of the SEC, to the U.S. Attorney General or to one or more state attorneys general for possible criminal prosecution.²³ Indeed, if the board discovers a potential violation of the securities laws by any person in the course of one of its enforcement investigations, Sarbanes-Oxley requires the board to notify the SEC about the matter and “thereafter coordinate its work with the work of the Commission’s Division of Enforcement.”²⁴ Where a potential violation is identified during an inspection, Sarbanes-Oxley appears to contemplate referral to the SEC only if the suspected violator is a registered firm or associated person,²⁵ but the board’s own rules make clear its intent to refer such matters regardless of who is the suspected violator.²⁶

Be Prepared

Having recently issued reports on its first round of limited inspections of the Big Four accounting firms, the PCAOB has now begun its regular full-scale inspection program, which will include a more comprehensive look at the Big Four firms every year and at all other registered accounting firms at least once every three years.

In recent testimony on Capitol Hill, PCAOB Chairman William J. McDonough predicted that his staff will collectively review more than 650 audit engagements in the course of

²² See Sarbanes-Oxley §§ 105(b)(3) and 105(c)(4).

²³ See *id.* §§ 104(c) and 105(b)(4).

²⁴ See *id.* § 105(b)(4).

²⁵ See *id.* § 104(c).

²⁶ PCAOB Rule 4004.

this year’s inspections.²⁷ If, as expected, the staff continues to seek interviews of the audit committee chairs of companies whose audit engagements are selected for review, then hundreds of audit committee chairs should expect to receive such a request in any given inspection cycle.

Beyond its inspection activity, the PCAOB recently hired its first Director of Investigations and Enforcement, and is currently recruiting an experienced staff of attorneys and accountants to conduct investigations and disciplinary proceedings in processes similar to those used by the SEC and the NASD.

In the course of such investigations and proceedings, the PCAOB staff is likely to request documents and testimony on a voluntary basis from a wide range of public company directors, officers, and employees, and it can seek the issuance of SEC subpoenas to force compliance with such requests if necessary. In this regard, Chairman McDonough recently told Congress that “we expect our investigations will often be a component of a larger investigation of the financial reporting [of the public company audit client] itself, and management’s role in that reporting. We therefore expect to work very closely with the SEC in such cases.”²⁸

With a warning like that, public companies cannot afford to ignore this new regulator and the havoc it is capable of initiating with a seemingly innocuous interview request. At a minimum, as part of their overall efforts to understand and cope with the new world created by Sarbanes-Oxley, companies should closely familiarize themselves with the role and jurisdiction of the PCAOB before the board’s staff comes seeking information.

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²⁷ William J. McDonough, Testimony Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, June 24, 2004, at 11 (available at http://www.pcaobus.org/transcripts/2004-06-24%20-%20McDonough_Testimony.pdf).

²⁸ *Id.*