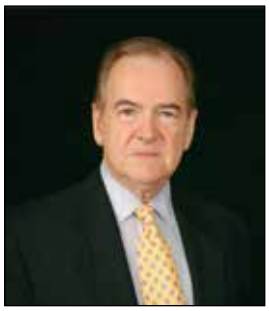
Parallel Proceedings in Accounting Litigation: The Position(s) Taken by the Self-Regulatory Organizations and State Boards of Accountancy



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AT TIMES, a CPA, or firm, may be enmeshed in civil litigation[1] and simultaneously be involved in an investigation concerning the same issues conducted by a government agency such as the Securities & Exchange Commission (SEC), the Federal Bureau of Investigation (FBI), the Department of Labor (DOL), or a State Board of Accountancy (BOA). In addition, the State Societies of CPAs and American Institute of Certified Public Accountants (AICPA), the primary self-regulatory organizations (SRO), may also be investigating an ethics complaint while litigation or a governmental investigation on the same issue(s) is in progress. This article addresses some of the factors present in the simultaneous investigation by the SROs and State Boards of Accountancy (BOA). It will also discuss the DOL's investigation of auditors of employee benefit plans (EBP) and the current position of the DOL on developing its own set of accounting standards and auditing procedures. These analyses are from the point of view of a CPA. It is left to the lawyers to

[1] Usually, arbitration may be included along with litigation even though the proceedings are confidential. Consult the specific SRO or BOA rules and regulations.

discuss the legal ramifications and strategies.

The SRO investigations are relatively simple. Well (aside from the AICPA which is a national organization) maybe it is not that simple, because, as with the law, we are a nation of States and other jurisdictions, each sometimes having different rules and regulations which affect the individual State and jurisdiction professional societies (there are 55 licensing jurisdictions the 50 States plus the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, the District of Columbia, Guam, and the Virgin Islands). Most of the SROs, however, use or are closely aligned with the AICPA Code of Professional Conduct and many have the AICPA conduct their ethics investigations. Virtually all the societies are members of the Joint Ethics Enforcement Program ("JEEP") administered by the AICPA. JEEP investigates and resolves ethics complaints.

The AICPA and each of the state societies have respective codes of professional conduct that their members are obligated to observe as a condition of their membership. The provisions of the codes of many state societies are identical with, or similar to, the provisions of the AICPA Code of Professional Conduct. Because of this identity and similarity, and because it is not uncommon for a CPA to be a member of both the AICPA and one or more state societies, the AICPA and virtually all of the state societies have joined together to create the JEEP.[2]

BOA rules and regulations, and the way they address issues, are more complicated and the possible ramifications for violations are far more severe than the SROs'. The BOA can revoke or suspend a CPA's license to practice and levy monetary penalties.

[2] http://www.aicpa.org/interestareas/professionalethics/resources/ethicsenforcement/pages/jointenforceprocedures.aspx

SROs • As quoted below, the JEEP Manual, which can be accessed on the AICPA website (http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/EthicsEnforcement/DownloadableDocuments/JEEPManual.pdf), allows for the deferral of an SRO ethics investigation, if it would unfairly prejudice the position of the CPA or firm in litigation or governmental investigations.

Deferral of an Ethics Investigation Due to Related Litigation or Regulatory Proceeding

Here are the most important JEEP Manual provisions (they are quoted directly) to consult regarding deferral of ethics investigations (with recommended language):

- **Section 3.31.** An investigation by an ethics committee may unfairly prejudice the litigation position of a respondent when the issues are concurrently the subject of (*a*) a formal legal proceeding pending before a state or federal civil or criminal court, (*b*) a formal proceeding or investigation by a state or federal regulatory agency or other organization that has been granted the authority by statute or regulation to regulate accountants (for example, a state board of accountancy, the SEC or Public Company Accounting Oversight Board), and/or (*c*) a formal appeal actually undertaken from a decision of a state or federal civil or criminal court or regulatory agency. Accordingly a letter of inquiry to a firm and an opening letter to a respondent must include the following paragraph:

  The [*named*] committee will, if you so request, defer this investigation provided it receives a written request to do so accompanied by evidence that the issues and parties involved in the investigation are currently the subject of: (1) a legal proceeding before a state or federal civil

or criminal court, (2) a proceeding or investigation by a state or federal regulatory agency or other organization that has been granted the authority by statute or regulation to regulate accountants (for example, a state board of accountancy, the U.S. Securities and Exchange Commission or Public Company Accounting Oversight Board), and/or (3) an appeal actually undertaken from a decision of a state or federal civil or criminal court or regulatory agency. This investigation will be resumed at the conclusion of the proceeding, investigation, or appeal. You will receive periodic inquiries from ethics division staff requesting information about the status of such proceeding, investigation, or appeal.

The letter of inquiry to the firm and the opening letter should also state that if the persons responsible for the engagement under investigation are no longer with the firm or no longer have control over the documents necessary to the investigation (for example, financial statements, working papers, litigation documents, correspondence, or memoranda), the firm should designate a partner of the firm to assume responsibility for preservation and presentation of the above described documents. The designated partner should be an AICPA and/or state society member and must have sufficient authority within the firm to assure the retention and presentation of the described documents. That partner's failure to fulfill this responsibility will be considered a violation of Rule 501—*Acts Discreditable*, of the AICPA's Code of Professional Conduct and/or a violation of AICPA bylaw 7.4.6 (and/or similar provisions of the state CPA society code or bylaws).

- **Section 3.32.** In certain unusual situations (for example, where the threat of litigation is present or where an accounting firm has prevailed in defense of a complaint against it but continues in the litigation as a counterclaimant or other third-party plaintiff), litigation deferral may be granted if appropriate under all the circumstances involved and if evidence is presented to the ethics committee regarding the existence of the litigation.

- **Section 3.33.** If the documentation submitted by the firm or respondent does not support his or her claim that the issues under investigation are the same as those involved in the litigation or proceeding, deferral of the ethics investigation should not be granted.

- **Section 3.34.** During the period in which an investigation is deferred, the committee conducting the investigation should at least every six months send written inquiries to the respondents and/or the person named by the firm to preserve and present documents related to the investigation requesting information about the status of the proceeding, investigation, or appeal. The name of the court, other authority, or agency and the docket number of the case should also be obtained. After the investigation has been deferred for five years, the written inquiry letter should be modified to request evidence that the matter that gave rise to the deferral is being actively pursued. In a situation in which it appears that the matter is not being actively pursued, an ethics committee may consider removing an investigation from deferral status. If a satisfactory response is not received within 30 days of the date of such an inquiry, a letter of noncooperation due to failure to cooperate should be sent certified mail, return receipt requested. The investigation should be resumed promptly when the

proceeding, investigation, and/or appeal is completed

Cooperation with Boards of Accountancy

The JEEP Manual also addresses its cooperation with the relevant BOA. In most instances, once the SRO investigation is completed, the investigation and findings can be shared with the BOA. The provisions (quoted directly) to consult are:

- **Section 5.5.** An ethics committee may conduct an investigation in cooperation with a state board of accountancy provided the respondent(s) in the investigation has given the ethics committee written permission to investigate the matter and to send a copy of the investigation file to the particular state board.

- **Section 5.6.** Where a state CPA society's bylaws allow for the sharing of disciplinary information with the state board of accountancy (or other regulatory body) and the society's members have voted to approve such bylaws, the sharing of information with the state board (or other regulatory body) is permitted without the specific consent of the respondent. However, the respondent should be advised that the information is being provided to the state board of accountancy (or other regulatory body).

The SRO examination usually can be deferred to accommodate any simultaneous litigation or governmental investigation on the same issue(s). However, this also gives the SRO access to the parties' discovery and the rulings in the litigation or investigation, where it is public, or not subject to a filed confidentially agreement. It can also initiate a BOA investigation.

STATE BOARDS OF ACCOUNTANCY • The National Association of State Boards of Accountancy ("NASBA") (http://nasba.org) has not conducted a study of BOAs' positions on the deferral of investigations that may run concurrent to litigation, or governmental investigations. However, the staff at NASBA offered the following observations based on their experience.

The answer to the question as to whether a BOA investigation will be deferred can be different depending on the jurisdiction and/or relevant circumstances. For example, in some jurisdictions, if the matter deals with a "Good Moral Character" issue that falls *outside* of the scope of the practice of public accounting, then the BOA might defer their investigation until they know the outcome of the litigation, or investigation. If the issue was *within* the scope of practice, the BOA generally would conduct its investigation concurrent with the litigation, or investigation, and the BOA investigator would make use of the discovery obtained during the civil litigation/trial, or investigation. However, the BOA would usually wait until the outcome of the civil litigation before making its ruling.

From the BOA's perspective there are good policy reasons for deferring an investigation:

- **Public vs. private disputes.** The BOA is responsible for protection of the general public rather than obtaining monetary damages for a CPA's mistakes;

- **Conservation of resources.** Private litigants obtain evidence and develop legal positions through discovery, motions and court rulings, which the BOA can use later in its investigation;

- **Avoid being leveraged.** The threat of a complaint to a BOA could otherwise be abused to pressure a defendant to agree to, or increase, a monetary settlement in a private dispute even when not justified; and

- **Narrower scope of investigation.** Although the civil complaint might include an

> unending array of issues, often the BOA only has jurisdiction over violations of standards, dishonesty or gross negligence. (See, e.g., UAA Section 10(a)(5): "Dishonesty, fraud, deceit or gross negligence in the performance of services.")[3]

Some BOA's rules expressly provide for the possibility of deferral, e.g., Arkansas Board Rule 11.1 (http://www.asbpa.arkansas.gov/Websites/accountancy/images/Board_Rules_Complete_Set_2-26-16.pdf):

> (c) (1) An investigation shall not be deferred or suspended without the approval of the Board even though the person being investigated is made a party to civil litigation or is prosecuted in a criminal action, notwithstanding that either of such proceedings involves the subject matter of the investigation. The prosecution of an accused in such criminal proceedings shall not be a bar to disciplinary proceedings, nor shall the finding, judgment or decree of any court in such civil proceedings to which the Board is not a part be binding on the Board.
> (2) The Board may defer an investigation of a case in which the accountant is a party to litigation, civil or criminal, provided that the accountant executes an agreement in a form acceptable to the Board providing that the terms of any settlement and the product of discovery generated during the litigation shall be produced upon request by the Board. (Emphasis added.)

Many BOAs have handled the situation and deferred cases by using a "Litigation Monitoring Consent Order (LMCO). Using the LMCO, the BOA preserves all of its prerogatives (and no laches or statute of limitations runs), while the respondent avoids defending multiple actions from various regulatory bodies.

Whether a BOA investigation will be deferred for litigation or a governmental investigation is very Jurisdiction and circumstance specific.

THE DEPARTMENT OF LABOR AND EMPLOYEE BENEFIT PLAN AUDIT INVESTIGATIONS AND PROPOSAL • The DOL is seeking federal legislation to allow the Secretary of Labor to promulgate accounting and auditing standards for EBPs. It also is asking for the authority to require auditors responsible for EBP audits to take educational courses relevant to EBP issues. In May 2015, the DOL issued a report titled, *Assessing the Quality of Employee Benefit Plan Audits* (the "DOL Report") (http://www.dol.gov/ebsa/pdf/2014AuditReport.pdf).

The DOL Report found significant deficiencies in the audits of EBPs. Smaller audit practices had the greater incidences of deficiencies. The major findings, conclusions and recommendations are listed in the report in the Executive Summary (the full report is 191 pages). The findings from the Report are as follows:

> Overall, EBSA's review found that 61% of the audits fully complied with professional auditing standards or had only minor deficiencies under professional standards. However, 39% of the audits (nearly 4 out of 10) contained major deficiencies with respect to one or more relevant GAAS requirements which would lead to rejection of a Form 5500 filing, putting $653 billion and 22.5 million plan participants and beneficiaries at risk. These figures reflect increases in the amount of plan assets and number of plan participants at risk compared with prior EBSA studies. Addition

[3] See the UAA at http://www.aicpa.org/advocacy/state/downloadabledocuments/uaamodelrules2014.pdf Model rules under the UAA are at http://www.aicpa.org/advocacy/state/downloadabledocuments/uaamodelrules2014.pdf

ally, the audit review supports the following findings:

- There is a clear link between the number of employee benefit plan audits performed by a CPA and the quality of the audit work performed. Analysis of the data indicates a wide disparity between those CPAs who perform the fewest plan audits and those firms that perform the largest number of plan audits. CPAs who performed the fewest number of employee benefit plan audits annually had a 76% deficiency rate. In contrast, the firms performing the most plan audits had a deficiency rate of only 12%.

- The accounting profession's peer review and practice monitoring efforts have not resulted in improved audit quality or improved identification of deficient audit 2 engagements. In 4 of the 6 audit strata, a substantial number of CPA firms received an acceptable peer review report, yet had deficiencies in the audit work that EBSA reviewed.

- CPA firms that were members of the American Institute of Certified Public Accountants' (AICPA) Employee Benefit Plan Audit Quality Center tended to produce audits that have fewer audit deficiencies. Overwhelmingly, most CPAs in the two smallest audit strata are not Employee Benefit Plan Audit Quality Center members.

- Training specifically targeted at audits of employee benefit plans (EBPs) may contribute to better audit work. As the level of EBP-specific training increased, the percentage of deficient audits decreased.

- Of the 400 plan audit reports reviewed, 67 (17%) of the audit reports failed to comply with one or more of ERISA's reporting and disclosure requirements. Based on those findings the DOL concluded in the Report that (again, this is a direct quote):

It appears that the quality of employee benefit plan audits has not improved since EBSA's previous studies given an overall deficiency rate for plan audits of 39%. Additionally, EBSA concludes that:

- Once again, the smaller the firm's employee benefit plan audit practice, the greater the incidence of audit deficiencies.

- Audit areas that are unique to employee benefit plans such as contributions, benefit payments, participant data and party-in-interest/prohibited transactions, continue to lead the list of audit deficiencies. As EBSA found in its two previous studies, CPAs often failed to consider these unique audit areas and, therefore, performed inadequate audit work.

- CPAs failed to comply with professional standards either because they were not adequately informed about employee benefit plan audits, or failed to properly utilize the technical materials that were in their possession. Audit partners in firms performing a greater number of plan audits tended to have a greater amount of employee benefit plan specific training. In a number of instances, however, even having the proper technical guidance did not ensure that a quality audit was performed.

- The Practice Monitoring Peer Review process established by the AICPA and administered by sponsoring state CPA societies does not appear to be an effective tool in

identifying deficient plan audit work and ensuring compliance with professional standards. While selecting an employee benefit plan audit is a required part of the peer review process (where applicable), CPAs who performed deficient audits often received acceptable peer review reports.

- Members of the AICPA's Employee Benefit Plan Audit Quality Center (EBPAQC) tend to have fewer audits containing multiple GAAS deficiencies. Additionally, non EBPAQC member firms tend to have a larger number of GAAS deficiencies, per audit engagement, than EBPAQC members.

The Report makes the following recommendations (quoted):

Enforcement

1. Revise case targeting to focus on:

    a. CPA firms with smaller employee benefit plan audit practices that audit plans with large amounts of plan assets, and

    b. CPA firms in the 25-99 plan audit strata given their high deficiency rates and the amount of plan assets ($317.1 billion) and plan participants (9.3 million) at risk from deficient audits.

2. Work with the National Association of State Boards of Accountancy (NASBA) and the AICPA to improve the investigation and sanctioning process for those CPAs who perform significantly deficient audit work. Work with NASBA to get state boards of accountancy to accept the results of investigations performed by EBSA or the AICPA's Professional Ethics Division, in order to use those results in disciplining CPAs (at the state licensing board level).
3. Amend ERISA to make sure the annual reporting civil penalties focus on the responsible party. Under this proposal, the Secretary of Labor would be authorized to assess all or part of the current annual reporting civil penalty of up to $1,100 per day against the accountant engaged to do an ERISA plan audit if the plan's annual report is rejected due to a deficient audit or because the accountant failed to meet the standards for qualification to perform an ERISA plan audit.

4. Work with the AICPA's Peer Review staff:

    a. to streamline the peer review process and make it more responsive in helping to improve employee benefit plan audit quality.

    b. to ensure that CPAs who are required to undergo a peer review have in fact had an acceptable peer review.

    c. to identify those CPAs who have not received an acceptable peer review and refer those practitioners to the applicable state licensing boards of accountancy.

Regulatory/Legislative

5. Amend the ERISA definition of "qualified public accountant" to include additional requirements and qualifications necessary to ensure the quality of plan audits. The Secretary of Labor would be authorized to issue regulations concerning the qualification requirements.

6. Amend ERISA to repeal the limited-scope audit exemption. This exemption prevents accountants from rendering an opinion on the plans' financial statements for assets held in regulated

entities such as financial institutions. When auditors have to issue a formal and unqualified opinion, they have a powerful incentive to rigorously adhere to professional standards ensuring that their opinion can withstand scrutiny. The limited scope audit exemption undermines this incentive by removing auditors' obligations to stand behind the plans' financial statements.

7. Amend ERISA to give the Secretary of Labor authority to establish accounting principles and audit standards that would protect the integrity of employee benefit plans and the benefit security of participants and beneficiaries. Under this approach, the Secretary of Labor would be authorized to establish standards that address financial reporting issues that are either unique to or have substantial impact upon employee benefit plans

The AICPA Professional Ethics Division also conducted a study of the most frequent violations of professional standards and issued a report as of April 30, 2015 listing those deficiencies (http://www.aicpa.org/interestareas/professionalethics/resources/ethicsenforcement/downloadabledocuments/employeebenefitplanreport.pdf). The AICPA study did not analyze the percentage of audits containing deficiencies, or the size of the CPA firms with the most deficiencies

SELF-REPORTING REQUIREMENTS • Uniform Accountancy Act Model Rule 11.2 addresses the CPA's, or firm's, responsibility to report convictions, judgments, and results of administrative proceedings. Virtually all BOAs have this or a similar provision in their specific rules. It is important to review the rules in a CPA's jurisdiction to determine if litigation and investigation findings need to be reported to the BOA. Remember that arbitrations may be treated in a similar fashion even though the proceeding is confidential (check the rules). Failure to comply could lead to a fine, or suspension or revocation of the CPA's license to practice. The following is the language from Rule 11-2 – Reporting convictions, judgments, and administrative proceedings:

(a) Subject to Section 4(j) of the Act, Licensees shall notify the Board, on a form and in the manner prescribed by the Board, within thirty (30) days of:

(1) Receipt of a peer review report pursuant to Rule 7-3(h)(3), or a PCAOB firm inspection report containing criticisms of or identifying potential defects in the quality control systems.

(2) Receipt of a second consecutive peer review report that is deficient pursuant to Rules 7-3(h)(2); or

(3) Imposition upon the licensee of discipline, including, but not limited to, censure, reprimand, sanction, probation, civil penalty, fine, consent decree or order, suspension, revocation, or modification of a license, certificate, permit or practice rights by:

(i) the Securities and Exchange Commission (SEC), PCAOB, Internal Revenue Service (IRS) (actions by the Director of Practice); or

(ii) another state board of accountancy for any cause other than failure to pay a professional license fee by the due date or failure to meet the continuing professional education requirements of another state board of accountancy; or

(iii) any other federal or state agency regarding the licensee's conduct while rendering professional services; or

(iv) any foreign authority or credentialing body that regulates the practice of accountancy.

(4) Occurrence of any matter reportable that must be reported by the licensee to the PCAOB pursuant to Sarbanes-Oxley Section 102(b)(2)(f) and PCAOB Rules and forms adopted pursuant thereto;

(5) Notice of disciplinary charges filed by the SEC, PCAOB, IRS, or another state board of accountancy, or a federal or state taxing, insurance or

securities regulatory authority, or foreign authority or credentialing body that regulates the practice of accountancy;

(6) Any judgment, award or settlement of a civil action or arbitration proceeding of $150,000 or more in which the licensee was a party if the matter included allegations of gross negligence, violation of specific standards of practice, fraud, or misappropriation of funds in the practice of accounting; provided, however, licensed firms shall only notify the Board regarding civil judgments, settlements or arbitration awards directly involving the firm's practice of public accounting in this state; or

(7) Criminal charges, deferred prosecution or conviction or plea of no contest to which the licensee is a defendant if the crime is:

(i) any felony under the laws of the United States or of any state of the United States or any foreign jurisdiction; or

(ii) a misdemeanor if an essential element of the offense is dishonesty, deceit, or fraud.

(b) The licensee designated by each CPA firm pursuant to Section 7(c)(2)(A) of the Act (as responsible for the proper registration of the firm) shall report any matter reportable under this rule to which a non-licensee owner with a principal place of business in this state is a party.

(c) Reports of pending matters or reports of private litigation resolved by settlement or arbitration shall be deemed confidential records not subject to public disclosure (to the extent permitted by this State's law on Public Records) unless and until the pending matters are concluded or the Board commences a contested case proceeding based upon the subject matter of such reports.

(d) During the pendency of a reported matter, the reporting licensee may submit a written explanatory statement to be included in the licensee's record. If reported charges or allegations are subsequently concluded in the licensee's favor or otherwise closed without disciplinary action by this Board, upon the reporting licensee's request, documents received pursuant to said report shall be expunged from the Board's records.

Comment: States should consider reducing or dropping a reporting requirement for pending matters or reports of private litigation/arbitration if complying with the request requires the disclosure of otherwise confidential information, and their state laws require such reports to be treated as public records since the potential for abuse might outweigh the regulatory interest in such information. Boards adopting this rule should also consider expunging any self-reported records of charges or allegations that are dropped or otherwise resolved in favor of the reporting licensee and which are maintained by the Board as public records. In the alternative, States should defer implementation of self-reporting of such matters until the State has adopted Section 4(j) of the UAA Statute. See also the reporting requirements set out in Rule 5.

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