Counsel's Role When Situations Go Bad During Financial Audits

A Few Reflections on Maintaining Positive Auditor Relations

By Scott Sorrels and Laurance Warco

Understand the Auditor's Reporting Provision

Section 10A of the Securities Exchange Act of 1934 is commonly known as the "reporting up and reporting out" provision applicable to public company auditors. Under Section 10A, if auditors "detect or otherwise become aware" of information indicating that an illegal act (whether or not perceived to have a material effect on the issuer's financial statements) has or may have occurred, they must do two things:

1. Determine whether it is likely that an *illegal act* has occurred and, if so, determine and consider the possible effects of the illegal act on the issuer's financial statements; and
2. Inform the issuer and ensure that the audit committee is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the auditors in the course of the audit, unless the illegal act is clearly inconsequential.

Know the Definition of an Illegal Act

Contrary to common intuition, an illegal act does not necessarily require knowledge or intentional misconduct. The statute itself defines an illegal act to mean "an act or omission that violates any law, or any rule or regulation having the force of law." The U.S. Securities and Exchange Commission (SEC) takes the position, for example, that a nonintentional violation of the books and records provisions of Section 13(b)(2) of the Securities Exchange Act of 1934 is sufficient to state a violation that qualifies as an illegal act under Section 10A. Although it is difficult to equate a books and records violation with, say, a major embezzlement, both situations are covered by Section 10A's use of illegal acts and require a measured but serious response.

Build a Positive Record from the Start

The Section 10A process often will begin with a telephone call followed by a formal notice as part of the accounting firm's initial notice efforts, shifting the burden to the company to react accordingly. At the end of the day, the auditor will expect the company to adequately inform the audit committee regarding any potential Section 10A issues. A typical response may be to conduct an investigation, take timely and appropriate remedial action with respect to any illegal acts, and inform the auditor of the actions taken. If the auditors are not satisfied with the results of the investigation or with the remedial actions taken and the illegal act has a material effect on the company's financial statements, the auditors' next step will be to report their conclusions directly to the company's board of directors.

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If the matter is not addressed to the satisfaction of the auditors at the board level, the "reporting out" provision of Section 10A requires the board of directors to inform the SEC once the auditors have informed the board that the

auditors are not satisfied with the remedial actions taken by the company. Finally, if the company does not report the situation to the SEC within the one-business-day period provided by Section 10A, the auditors are required to independently report their findings to the SEC and may choose to resign from the auditing engagement. On the other hand, if the company takes appropriate remedial measures that satisfy the auditors, neither the company nor the auditors have any SEC reporting obligations.

Consider (New) Outside Counsel for the Investigation

Upon receiving notice of a Section 10A issue, the company should consider engaging outside counsel to conduct an unbiased investigation regarding the alleged, potential illegal act. There are several advantages to having outside counsel perform the investigation.

- First, until waived, any findings or conclusions reached by outside counsel and communicated to the company are protected by the attorney-client privilege.
- Second, depending on the nature of the alleged, potential illegal act, outside counsel will likely have experience and specialized expertise in analyzing whether the behavior at issue constitutes "an act or omission that violates any law, or any rule or regulation having the force of law."
- Third, having an unbiased external person or organization conduct the investigation provides for an objective analysis of the situation.

On this last point, Howard A. Scheck, Chief Accountant for the Enforcement Division of the SEC, recently noted (albeit speaking on his own behalf rather than on behalf of the SEC) that one of the factors the SEC considers in its evaluation of the company's response to a Section 10A notification is whether the outside counsel engaged by the company to conduct the investigation is truly objective. Thus, if outside counsel engaged to conduct the investigation routinely handles a large number of matters for the company or is somehow already tied to the acts or omissions being investigated, the company should consider engaging another firm or attorney to provide the analysis.

Make Sure Nothing Is Destroyed

Should a Section 10A matter be disclosed to the government at a later time, the SEC will almost always inquire into what the company did to preserve evidence. This early step, if handled inadequately, can forever change the government's perception of

So What Is an Illegal Act?

The SEC has taken an expansive view of the term "illegal act" as used in Section 10A. That view does not necessarily require fraudulent intent. Illegal acts may thus include:

- Activities directly intended to defraud investors by dissemination of false or misleading financial statements;
- Misappropriations of assets;
- Other types of illegal acts that are not directed at the financial statements per se but may have a direct effect and are likely a form of fraud;
- Unusual situations in which other types of misconduct are discovered, such as significant violations of tax, environmental, antitrust or other laws which could materially impact the financial statements and, if not properly disclosed, might also constitute fraud; and
- An intentional misstatement of immaterial items in a registrant's financial statements that violates Section 13(b)(2) (the books and records provision).*

Even "intentional" can have a different meaning than its common interpretation. For example, the SEC has maintained that an intentional misstatement of an immaterial item requires only a knowing act of making a particular inaccurate book entry without knowledge at the time that the entry was in fact incorrect.

*Section 13 of the Securities Exchange Act of 1934 sets out the requirements for filings with the SEC. This section generally requires issuers to make and keep their books and records in "reasonable detail" to accurately reflect transactions and dispositions of assets. This section further requires issuers to maintain an internal accounting control system that provides reasonable assurance that;

a. Management authorizes transactions;
b. Transactions are recorded in such a way as to prepare financial statements in accordance with generally accepted accounting principles;
c. Management authorizes access to assets; and
d. Recorded and actual assets are compared on a reasonably frequent basis.

Neither materiality nor scienter is a necessary element of a violation of Section 13(b)(2), although Section 13 itself states that no criminal liability will be imposed for a violation of Section 13(b)(2), the key books and records provision, absent knowing misconduct.

the good faith and competence of the subsequent investigation. Electronic evidence, particularly e-mail, is a significant concern, given that it can routinely be destroyed as part of the company's normal electronic information storage policies. Mr. Scheck similarly noted that the SEC considers actions taken to preserve such evidence in its evaluation of the company's response to a Section 10A notification.

Expect an "Audited" Investigation

The goal in many of these situations is to fairly and rapidly respond to the concerns identified by the auditors and, all things being equal, to do everything reasonably possible to satisfy the auditors' concerns in order to allow the auditors to continue their engagement.

As one might expect, if the auditors' concerns have escalated to the degree that they are formally reporting a Section 10A issue, the auditors may be concerned about fulfilling their own professional obligations and avoiding exposure. The auditors will evaluate every phase of how the company and the audit committee respond to the concerns. And, the larger firms often task their own forensic and litigation support units to perform a shadow "audit" of the investigation conducted by the company. When the auditors' concerns involve issues of management integrity or the ability of the auditors to rely on a management letter of representation, the auditors will closely examine how issues of key internal controls are evaluated and resolved to determine whether the auditors can continue to rely on the company's representation or whether they should resign from the representation, which significantly complicates the situation.

Stay Focused on the Goal

In times of crisis and confusion, staying focused on the goal is often difficult. A calm, objective assessment of the situation is critical, particularly if everyone else appears to be losing perspective and objectivity. The goal in many of these situations is to fairly and rapidly respond to the concerns identified by the auditors and, all things being equal, to do everything reasonably possible to satisfy the auditors' concerns in order to allow the auditors to continue their engagement. Changing auditors, particularly in the midst of audit season, is unpleasant at best. Unfortunate timing and circumstances, such as a crisis late in the fiscal year after the auditors' fieldwork is underway, may put the company in a situation where other auditing firms are unwilling or unable to assist, new engagement notwithstanding. Maintaining objectivity and responding appropriately, yet calmly, will help to ultimately resolve the Section 10A issue presented and assure the auditors that the company takes its securities obligations seriously.

Scott Sorrels, a member of Sutherland's Litigation Practice Group, has practiced in the securities regulatory and enforcement area for more than 25 years. His practice involves representing public and private companies, their officers and directors, along with financial institutions, accounting and law firms and their principals, in SEC and bank regulatory enforcement actions, Department of Justice investigations and criminal prosecutions, and complex civil litigation. Laurance Warco, a member of Sutherland's Litigation Practice Group, has more than ten years of litigation experience, including the defense of all Big Four accounting firms, law firms, corporations and individuals in numerous federal and state courts.