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INVESTIGATION AND REPORTING OBLIGATIONS UNDER SECTION 10A OF THE SECURITIES EXCHANGE ACT

When an Auditor of a Public Company Determines that an Illegal Act is "Likely" to Have Occurred, it Must Investigate and Report Upwards. Failure to Heed Irregularities and to Act Promptly Has Led the Commission, in Some Notable Cases, to Censure Firms, Bar Them from Practice, Impose Penalties, and Require Disgorgement of Fees.

By Gary DiBianco and Andrew M. Lawrence*

The Securities and Exchange Commission is continuing to focus on independent public accountants as whistleblowers on financial fraud, as reflected in several recent actions alleging under Section 10A of the Securities Exchange Act that accountants failed adequately to investigate or report potential illegal acts by management. Some of these actions relate to auditors' obligations when they detect potential management fraud. Other SEC actions, however, suggest a lower threshold: that disagreements over the application of accounting standards could trigger an auditor's 10A obligations. In the real-time context of an ongoing audit, assessing the significance of such a dispute remains a difficult – and subjective – question. Settled SEC enforcement actions provide some guidance for issuers and auditors in a 10A situation, but there are significant practical concerns and pressures when a 10A investigation complicates completion of an audit and the filing of an issuer's financial statements.

This article analyzes recent settlements as they may inform an auditor's duties, first to investigate and then to report under Section 10A. We also describe the investigation process that may unfold when an auditor identifies a potential illegal act within the meaning of Section 10A, and we identify issues that auditors and issuers are likely to confront during the inquiry to determine whether an illegal act has occurred.

OBLIGATIONS UNDER SECTION 10A

Section 10A of the Exchange Act was enacted as part of the Private Securities Litigation Reform Act of 1995, and amended by the Sarbanes-Oxley Act of 2002.[1] The

[1] 15 U.S.C. 78j-1. The Sarbanes-Oxley Act amended Section 10A, adding prohibitions on the provision of non-audit services; requiring that the audit committee pre-approve services (both audit and non-audit) provided by the auditor; requiring audit partner rotation every five years; requiring the auditors to report

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statute requires a registered public accounting firm ("auditor" or "independent public accountant") to take certain actions when, during the course of an audit, the auditor becomes aware of information that indicates that an illegal act, whether or not material to the issuer's financial statements, has or may have occurred. Specifically, upon becoming aware of such an act, the auditor must:

- determine whether it is "likely" that an illegal act has in fact occurred;
- if so, determine and consider the possible effect of the illegal act on the issuer's financial statements;
- inform the appropriate level of management; and
- ensure that the audit committee of the issuer is adequately informed with respect to the illegal act, unless the illegal act "is clearly inconsequential."

Investigation of a Potential Illegal Act

For a number of reasons, the trigger for potential investigation under Section 10A is low. First, the statute creates obligations for an auditor when the auditor learns of information indicating that an illegal act "has or may have occurred." Thus, the auditor's duties come into play upon discovery of the possibility of an illegal act, rather than a finding that such an act occurred. Second, the statute specifies that even an immaterial, potential, illegal act must be investigated. Third, what constitutes an "illegal act" is broadly defined in Section 10A to mean "an act or omission that violates any law, or any rule or regulation having the force of law." The SEC interprets Section 10A to apply to illegal acts beyond financial misconduct and even beyond an employee's business responsibilities. Specifically, Staff Accounting Bulletin 99, notes that – in contrast to audit literature – the definition of "illegal act" in Section 10A does not exclude "'personal misconduct by the entity's personnel unrelated to their business activities.'"[2] Accordingly, strict application of SAB 99 and the broad definition of "illegal act" would require an auditor to trigger 10A investigatory procedures upon learning of possible misconduct by a company employee, even if the misconduct were not related to the employee's professional duties, or was not perceived to have a potential material affect on the company's financial statements.

As a practical matter, reported settlements under Section 10A suggest that SEC enforcement action is focused on instances where the possible illegal act directly related to the fair presentation of an issuer's financial statements. For example, in *In the Matter of Seidelman*, the Commission filed a settled administrative order against Gary L. Seidelman, a partner of PricewaterhouseCoopers LLP ("PwC"), concerning failure to investigate the propriety of a material bill-and-hold transaction.[3] Seidelman, a certified public accountant, was the engagement partner responsible for the 2000 audit of Anicom Inc., a distributor of wire and cable products that filed for bankruptcy in January 2001. The administrative order specifies that a suspicious, material $9.5 million sales transaction booked in the first quarter of 2000 was brought to the audit team's attention, but that the audit team did not obtain sufficient evidence that revenue from the transaction was legitimate. Specifically, the audit team was aware that sale was made as a "bill-and-hold" (in which the seller records revenue but does not ship the product or receive

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to the issuer on critical accounting policies and on all material communications with management (including in particular, discussion of alternative treatments of financial information); restricting the auditor's employees from serving as CEO, CFO or Chief Accounting Officer in the year after leaving the firm; and imposing new requirements on audit committees. This article focuses on the reporting obligations under Section 10A.

[2] Materiality, SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 n.41 (Aug. 19, 1999) (hereafter "SAB 99") (quoting AICPA Codification of Statements on Auditing Standards (hereafter "AU") § 317.02).

[3] Exch. Act Rel. No. 50179 (Aug. 11, 2004).

payment), but despite numerous requests by Seidelman and the engagement team, Anicom never produced documentation to confirm two of the key criteria to allow revenue to be recognized: "that Anicom's customer, not Anicom, initiated the bill-and-hold, and that there was a fixed delivery schedule for the product."[4] Standing alone, these failures may not have warranted scrutiny under Section 10A, but the Commission's order refers to several "red flags" from the 1999 audit: (1) Anicom had commissioned an internal investigation of allegations that a member of management was engaged in fraudulent billing practices; (2) following the internal investigation, the SEC enforcement division had requested documents from Anicom, and the audit team was aware of this request; (3) in December 1999, Seidelman had reevaluated Anicom as "high-risk"; and (4) in January 2000, Seidelman learned of allegations of improper sales activities. The order concludes that Anicom's inability to document the 2000 bill-and-hold transaction, in light of the red flags from the 1999 audit, should have led Seidelman to initiate procedures under Section 10A to determine whether recognition of revenue from the bill-and-hold was an illegal act.[5]

Given that it is not unusual for auditors to identify instances of questionable revenue recognition in the course of an audit, it appears that the key factor in triggering 10A obligations in the Anicom audit were the so-called "red flags" from the 1999 audit. Whether questionable revenue recognition on a single, material transaction would trigger 10A procedures remains highly debatable, because the language of the statute suggests that there would need to be a suggestion of impropriety before the provision is activated.

The Commission's administrative order in *In the Matter of PKF* similarly focuses on several indications of potential fraud that should have raised flags for the audit team. In its order, the Commission cited PKF, a United Kingdom accounting firm, for violations in connection with PKF's 2000 audit of AremisSoft Corporation ("AremisSoft").[6]

According to the Commission's complaint and administrative order, PKF became aware of information during its 2000 audit indicating that illegal acts had or may have occurred but failed to report this information to AremisSoft's management, board of directors, or audit committee. The Commission's order describes several "warning signs" noted in the work papers of the audit staff. First, PKF was aware that revenue from three contracts was questionable, because AremisSoft was in a dispute about the contracts with one of the Big Four accounting firms, which had been engaged in connection with preparation of AremisSoft's S-1 registration statement. The dispute arose, in part, following an anonymous letter to the SEC alleging that AremisSoft's registration would contain "fraudulent information" about revenue. Moreover, in the midst of the dispute, AremisSoft's Chief Financial Officer resigned. The Commission's order states that AremisSoft's financial statements – audited by PKF – included revenue from these contracts, which were "shams." Second, the Commission alleged that PKF was told during review procedures for the second quarter of 2000 that revenue had been improperly delayed from the first quarter to the second quarter. Third, the order states that correspondence among partners on the PKF audit team indicated suspicion about revenue and a lack of general documentation from one of AremisSoft's Cyprus subsidiaries. Fourth, the Commission alleged that ledger entries at the Cyprus subsidiaries showed "obvious irregularities" and "appeared to be created at the same time – after AremisSoft's year end." Finally, the order describes irregularities in the accounts receivable confirmations returned to PKF, in that none were originals, many had identical or similar handwriting, and many were returned on or around the same date. The Commission alleged that failures to investigate these issues constituted violations of Section 10A.[7]

[4] Exch. Act Rel. No. 50179 (Aug. 11, 2004).

[5] *In the Matter of Seidelman*, *supra* note 3. The Commission's order found that Seidelman engaged in improper professional conduct in connection with the audit under Rule 102(a)(1)(ii). The Commission also found that Seidelman violated Section 10A(b)(1) of the Exchange Act, and that he caused Anicom's reporting violations under Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder. Without admitting or denying the Commission's findings, Seidelman consented to a censure and a three-year bar from appearing or practicing before the Commission as an accountant.

[6] *In the Matter of PKF*, Sec. Act Rel. No. 8675 (Apr. 12, 2006). On April 12, 2006, the Commission filed a settled civil action in the United States District Court for the Southern District of New York and a related administrative proceeding against PKF, a United Kingdom-based accounting firm, and its former partner, Anthony Frederick John Mead, in connection with the firm's failed 2000 audit of AremisSoft. In 2002, AremisSoft filed bankruptcy after announcing it was unable to substantiate $90 million of revenues reported in 2000.

[7] In addition, according to the Commission's order, PKF and Mead knew or should have known that generally accepted auditing standards and GAAP were not followed in the 2000 AremisSoft audit. The order also stated that PKF partner Stuart

As with the Anicom audit, the AremisSoft audit appears to have led to scrutiny under Section 10A because of repeated indications of improper conduct by management. It is not clear that any of the "warning signs" standing alone would have triggered 10A obligations.

Reporting Requirements

If an illegal act has been detected, the auditor is required to report, as soon as practicable, its conclusions directly to the company's board of directors if it concludes that:

- the illegal act will have a material effect on the financial statements;
- senior management has not taken, and the board of directors has not caused senior management to take, "timely and appropriate remedial action" with respect to the illegal act; and
- the failure to take remedial action is reasonably expected to warrant a departure from a standard auditor's report or the auditor's resignation.

After the board of directors has received such a report from the company's auditors, the board has one business day to inform the SEC that it has received the report and give the accountant notice that it so informed the Commission. An accountant who does not receive such notice must either resign from the engagement or furnish the Commission with a copy of its report.

Settled cases provide some level of insight on the SEC's views of the appropriateness of an auditor's response when there has been a determination of an illegal act. First, it is clear that when auditors are aware of fraud and do not report it, or they participate in the fraud, the SEC will contend that Section 10A has been violated. The Commission's order in *In the Matter of Davis* is illustrative in this regard.[8] There, the Commission alleged that Gregory Davis ("Davis") and BKR Metcalf Davis ("Metcalf Davis") aided and abetted Chancellor Corporation in financial statement fraud and that the failure to report this fraud violated Section 10A. Metcalf Davis served as Chancellor's independent auditor from 1999 through 2001, and Davis was the engagement partner for Chancellor's audits for 1998 and 1999, and a 2000 restatement of the 1998 and 1999 financial statements.[9] The Commission alleged that in connection with Chancellor's 1998 and 1999 audits, Davis and Metcalf Davis aided and abetted Chancellor in materially overstating its revenue, income, and assets, providing materially misleading disclosure, and materially misrepresenting and improperly disclosing fees owed to a related party, on various Commission forms.

The 10A allegations of the Commission's order focus on Chancellor's premature consolidation of MRB, a subsidiary it had decided to acquire. Chancellor had entered into a letter of intent to acquire MRB in August 1998, and the acquisition closed on January 29, 1999. Chancellor included MRB in its 1998 consolidated results from August 1, 1998 forward. The Commission's order explains that under GAAP, consolidation of the MRB entity would have been proper only if there was a written agreement giving Chancellor control of MRB as of August 1, 1998. The firm that audited Chancellor before Metcalf Davis had concluded that Chancellor did not have control of MRB as of that date, and had so informed Chancellor's Board and Audit Committee. The Commission's order alleges that in response, Chancellor's CEO and CFO fabricated an amendment to the acquisition agreement, which was never approved by MRB's shareholders. The auditors did not change their view of the acquisition date, and Chancellor dismissed them in February 1999. According to the Commission's order, the prior auditors informed Metcalf Davis of their views that MRB's results should not have been consolidated until the transaction closed in January 1999, and they informed Metcalf Davis that they were suspicious of the authenticity of the amendment document. The order alleges that, despite being aware of potential fabrication of the amendment and other documents, Davis and

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John Barnsdall backdated his concurring partner sign-off to the date of the audit report. Without admitting or denying the allegations, PKF consented to disgorgement of $309,048 in audit fees plus interest, and a $2 million penalty to be distributed to harmed investors. PKF also consented to a censure, and agreed to not accept audit engagements of new Commission registrant clients for one year. Mead consented to a $50,000 penalty, a censure, and a permanent bar from appearing or practicing before the Commission as an accountant. Barnsdall consented to a censure and a two-year bar from appearing or practicing before the Commission as an accountant.

[8] Exch. Act Rel. No. 51516 (Apr. 11, 2005).

[9] Chancellor was engaged in buying, selling and leasing new and used transportation equipment. In August 2001, one of Chancellor's creditors filed an involuntary bankruptcy action against Chancellor and the court appointed a receiver to liquidate the company's assets.

others at Metcalf Davis did not take any steps to verify, with MRB shareholders, the authenticity of the documents. Thus, the order concludes that Davis and Metcalf Davis violated Section 10A in that they (1) failed to investigate whether senior management of Chancellor had committed fraud in fabricating the document; and (2) failed to inform the Audit Committee of the suspected fraud.[10] The SEC's order focuses on the participation of Davis and Metcalf Davis in Chancellor's misconduct, where it seems fairly straightforward that failure to report fraud would form the basis for allegations under Section 10A.

The SEC's action against KPMG LLP in its audits of Xerox Corporation for failure to respond adequately under Section 10A, suggests a far lower threshold for reporting than participation in management fraud, and it indicates that the SEC may pursue a 10A violation if they believe an auditor's response is insufficient, even where the auditor informed senior management and the Company's Audit Committee of questionable accounting practices.[11]

On January 29, 2003, the Commission filed a complaint in the Southern District of New York charging that KPMG and four of the firm's senior partners engaged in securities fraud in connection with audit services provided to Xerox Corporation from 1997 to 2000. The Commission filed an amended complaint on October 3, 2003 to include a fifth senior audit partner. On April 19, 2005, KPMG agreed to settle the federal court litigation by consenting to the entry of a final judgment finding, among other things, that it violated Section 10A.[12] On October 6, 2005, the Commission settled with Joseph T. Boyle, the relationship partner on the audits of Xerox Corp. from 1999 through 2000.[13]

In its complaint, the SEC alleged that from 1997 through 2000, KPMG permitted Xerox to manipulate its accounting practices to close a $3 billion "gap" between actual operating results and results reported to the investing public. According to the Commission, during this period, Xerox used accounting actions at the end of financial reporting periods to increase equipment revenue and earnings through the improper acceleration of revenue from long-term leases of Xerox copiers and through manipulation of excess or "cookie jar" reserves. The SEC alleged that these "topside" accounting actions – allegedly made solely for the purpose of closing gaps between anticipated and actual results – violated GAAP, overstated Xerox's true equipment revenues by at least $3 billion, and overstated its true earnings by approximately $1.5 billion during the four-year period. The Commission alleged that while this was going on, KPMG auditors onsite at Xerox's domestic and international locations repeatedly cautioned the senior partnership at KPMG's headquarters about the improper revenue recognition practices pursued throughout Xerox. The SEC Order settling with KPMG acknowledges that KPMG informed the Xerox CFO and also the Audit Committee Chair that certain accounting practices related to price increases and lease extensions were wrong and should be discontinued, but faults KPMG for not communicating with the Xerox Board and Audit Committee until after the SEC had begun an investigation.

The complaint against KPMG may provide insight into the Commission's view of an auditor's duties under Section 10A, but these are not without controversy. First, the complaint alleges that, when it concluded that certain of Xerox's accounting practices did not conform with GAAP, KPMG should have forced Xerox to change the policies, and, if Xerox refused, to qualify its audit

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[10] Without admitting or denying the findings, Metcalf Davis consented to a censure, and a one-year bar on performing audit services for a public company. Metcalf Davis also consented to implement new procedures for its audit system, increase qualifications for its employees, and hire an independent CPA consultant should it decide to register with the PCAOB. Without admitting or denying the findings, Davis consented to a censure and a five-year ban from appearing or practicing before the Commission as an accountant.

[11] *SEC v. KPMG LLP*, Litigation Release No. 17954 (Jan. 29, 2003), *SEC v. KPMG LLP*, Litigation Release No. 18389 (Oct. 3, 2003); *In the Matter of KPMG LLP,* Exchange Act Release No. 51574 (Apr. 19, 2005); *SEC v. KPMG LLP, et al.,* Litigation Release No. 19191 (Apr. 19, 2005).

[12] Under the settlement with KPMG, the firm agreed to pay disgorgement of $9,800,000 (representing its audit fees for the 1997-2000 Xerox audits), prejudgment interest thereon in the amount of $2,675,000, and a $10,000,000 civil penalty, for a total payment of $22.475 million. KPMG also agreed to

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perform remedial undertakings designed to prevent future violations of the securities laws. As part of the settlement, the SEC agreed to dismiss the other claims asserted against KPMG in the federal court action.

[13] The SEC administrative order against Boyle alleged that Boyle was told that Xerox engaged in improper accounting, but did not report these likely violations to the Xerox Audit Committee, nor did he take any other steps required by law when told of the improper accounting. Boyle consented to a $100,000 civil penalty, a permanent injunction, and a suspension from appearing or practicing in front of the SEC as an accountant for one year.

opinion or resign – and notify the Commission of the reason for the resignation.[14] However, in real time, an auditor may consider disagreements over policies and application of accounting standards to be just that – a disagreement – and not evidence of an illegal act. The standard suggested by the complaint in Xerox is that an auditor must assess the subjective good faith of an issuer's position on application of GAAP.

Second, the Commission's complaint alleges that KPMG's Section 10A response was "too little, too late." In particular, the complaint alleges that KPMG asked Xerox's Audit Committee to investigate certain accounting issues only after the SEC's investigation already had commenced, and that KPMG should have conducted additional audit procedures to evaluate Xerox's practices.[15] The standard suggested is that reporting to management is insufficient, and that an issuer's Board and Audit Committee should be involved when an auditor has concluded that management's accounting practices are questionable. Again, however, the SEC's standard seems to require assessment of management's intent in applying accounting standards.

The SEC's action against Grant Thornton and Doeren Mayhew for audits of MCA Financial points to yet another potential obligation imposed by Section 10A: to report misstatements after the filing of an issuer's financial statements.[16] In the Grant Thornton matter, the SEC allegations are based on the theory that Section 10A is violated if misstated financials lead to a violation of the antifraud provisions of the securities laws, and auditors then fail to notify the issuer's Board and Audit Committee of the fraud.

In this "two-step" theory of a Section 10A violation, the Commission first alleged that the auditors were aware of material, related-party transactions that MCA failed to disclose in its 1998 annual financial statements and its fiscal year 1998 quarterly reports. Specifically, the Commission alleged that MCA did not disclose that "the borrowers on approximately $39.8 million of its approximately $102.2 million of mortgages held for resale and approximately $6.7 million of its approximately $20.7 million of land contracts held for resale" were a related party. The Commission further alleged that the Grant Thornton and Doeren Mayhew partners who worked on the 1998 audit of MCA were aware, through audit planning procedures and through review of work papers, of the related-party transactions. The Commission alleged that although the auditors were aware of the related-party transactions, and aware that they were not disclosed in MCA's financial statements, Grant Thornton and Doeren Mayhew issued reports containing an unqualified audit opinion of MCA's 1998 financial statements.

For the second step of the alleged violation, the Commission alleged that MCA sold two tranches of debt in May 1998, both based on registration statements and financial statements that failed to disclose the related-party transactions and incorporating the unqualified audit opinions. The Commission alleged that these failures constituted securities fraud (Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder). To make out a violation of Section 10A against the auditors, the Commission found that, through their audit procedures, the auditors read and were aware of MCA's annual and quarterly filings, were aware that they failed to disclose related-party transactions, and were aware that the filings were published in connection with sale of securities. Thus, the Commission alleged, the auditors were aware of an illegal act by MCA (the securities fraud), and their failure to inform MCA's Board of Directors of the illegal act was a Section 10A violation.[17]

[14] October 3, 2003 Complaint ¶ 132.

[15] Complaint ¶ 144.

[16] *In the Matter of Grant Thornton LLP*, Sec. Act Rel. No. 8355 (Jan. 20, 2004).

[17] As part of the Commission's August 5, 2004 order, Grant Thornton agreed to (1) pay disgorgement and prejudgment interest of $59,749; (2) pay a penalty of $1.5 million; (3) be censured for its alleged conduct; (4) require its entire professional staff to undergo fraud-detection training and provide at least $1 million to fund such training; and (5) suspend certain joint audits with other auditing firms for a period of five years.

Pursuant to the order, Doeren Mayhew, which voluntarily discontinued conducting public audits as of March 19, 2003, agreed not to accept new public company auditing engagements for six months. In addition, Doeren Mayhew agreed that if it engages in audits of public companies after the expiration of six months, it will establish and implement certain policies and procedures specifically designed to improve the quality of its public company audit practice for a period of three years. Doeren Mayhew also was censured and required to pay disgorgement and prejudgment interest of $115,126.86.

Also pursuant to the order, a Grant Thornton partner (Peter Behvens) and two Doeren Mayhew partners (Marvin Morris and Benedick Rybicki) were denied the privilege of appearing or practicing before the Commission for periods of five years, three years and one year, respectively, from the entry of the order.

The Commission's position in the MCA audit could be read to impose an ongoing disclosure duty under Section 10A by auditors, if they are aware or become aware of a material misstatement of an issuer's financials and know that the financials will be used in connection with a sale of securities. In such a scenario, the auditors would not only be gatekeepers in connection with an issuer's preparation of financial statements, but also whistleblowers on an improper act after the gates are closed.

SECTION 10A INVESTIGATIONS

Although the Commission's settled cases identify theories of enforcement and can assist in delineating the auditors' baseline duties, potential obligations under Section 10A frequently arise in situations that do not involve clear fraud or financial statement manipulation. In such cases, both auditor and issuer will want to resolve the situation to minimize disruption to the audit and to minimize potential liability. As a practical matter, issuers and accountants must assess Section 10A situations in real time, and several issues are likely to arise.

As a threshold matter, based on SAS 54, independent public accountants generally take the position that determining whether an act is illegal is outside of their professional scope and must be based "on the advice of an informed expert qualified to practice law."[18] Accordingly, when an auditor becomes aware of information to suggest that an illegal act has or may have occurred, it is common for the burden of conducting an investigation into the conduct identified by the auditor to be shifted to the company, through internal legal resources or outside legal counsel. In certain situations, the company's audit committee undertakes to supervise the investigatory work.

The investigation generally results in a report – either orally or in writing – assessing the conduct and possible remediation to the management, board, or audit committee group overseeing the response. The 10A statute is written to provide the company with an opportunity to take remedial actions and obviate the need for the auditor to report formally to the company's board, and the company's investigation and self-assessment are frequently a means of appropriately responding to information on potential illegal acts that have come to the attention of the auditor.

Conducting the Investigation

Who conducts the investigation depends in large part on the nature of the potential illegal acts. For example, where the issues are discrete and primarily related to analysis of ledger entries or accounting decisions, a company may see benefits to conducting the investigation internally. In contrast, where the auditor has raised questions about management's integrity or representations made to the auditor, the issuer may be more comfortable with external counsel leading the investigation.

Since at least the late 1990s, the SEC has increasingly focused on the so-called "independence" of outside counsel. This issue is reflected in the SEC's "Seabord factors," which state that in assessing a company's conduct in response to identification of improper conduct, the SEC will consider whether counsel who are retained to investigate have been previously engaged by management.[19] In the SEC's view, it is preferable for internal investigations to be conducted by counsel who have had no or minimal prior connections with company management. However, a company may perceive advantages to having counsel familiar with the company conduct the Section 10A investigation. For example, such counsel may have background knowledge of a company's business, financial department structure, and accounting issues, and, thus, may be able to initiate the investigation more expeditiously than counsel who do not have prior experience with the company. Communication between the issuer and auditor on the scope and the nature of the investigation may help both parties fulfill their duties under Section 10A.

Auditor's Ability to Continue Audit Procedures

Depending on the nature of the possible illegal act, the auditor may or may not be comfortable continuing to perform work in connection with quarterly reviews or an annual audit. In particular, if the conduct identified raises questions about the integrity of management from whom information and representations are required, the auditor may conclude that all work, or work on certain aspects of the review or audit, must be suspended until completion of the investigation. This "pencils down" approach is likely to delay an issuer in obtaining auditor approval of its quarterly and/or annual financial statements. Alternatively, the auditor may be willing to continue review or audit work, but unable to complete the review or conclude the audit until the 10A investigation is done. Either scenario may delay the

[18] AU § 317.03.

[19] Exch. Act Rel. No. 44969, Oct. 23, 2001.

filing of the statements, which raises public disclosure questions for the company.

It is frequently useful for the company representatives directing the investigation and the group conducting the investigation to speak, in as much detail as possible, with the auditors about the specific concerns that have been raised to ensure that they are accurately understood in setting the scope and priorities of the investigation. The company may also wish to share its investigation plan with the auditor – or the auditor may request access to the plan to assess whether the company's initial manner of addressing the conduct is appropriate.

Potential Waiver of Privilege

At various stages during the 10A investigation, there will be occasions to share information between the company and auditor that reflects legal strategy and legal advice and, thus, may be subject to the attorney work-product doctrine or the attorney-client privilege. Sharing information between the issuer and independent public accountant may be considered a waiver of such protections; the law in this area is frequently uncertain and varies significantly among jurisdictions.[20] As a practical matter, the sharing of information may be necessary to complete the 10A investigation process and to allow the company to understand the auditor's concerns and to allow the auditor to assess the company's remedial actions. Decisions about when to share information, and what information to share, should be made after consideration of potential waiver issues.

In some circumstances, an issuer may decide to share information with the auditor orally rather than in writing. Because monitoring and analyzing information provided to the auditor in connection with a 10A investigation is an element of the auditor's procedures, auditors usually document the information that has been provided to them in their work papers. Thus, even where information has been shared orally, auditors likely will have a written summary of investigation issues that may be sought by regulators or in civil litigation.

Disclosure

As previously noted, Section 10A mandates reporting by an auditor to a company's board of directors under certain circumstances, and the board must disclose such a report to the SEC within one day of receiving it from the auditor. The provision does not contain other specific disclosure requirements; accordingly, an issuer's disclosure obligations are evaluated under general standards. In the early stages of a 10A inquiry, and assuming the specific reporting requirements of the statue have not been invoked, two broad decisions on disclosure are usually presented: (1) whether (and if so, when) to make a voluntary self-disclosure to the SEC and, if warranted, criminal authorities; and (2) whether (and if so, when) to make a public disclosure.

In terms of disclosure to the government, much has been written elsewhere about the benefits and risks of self-disclosure, and setting forth all of the relevant considerations is beyond the scope of this article. In the 10A context – unlike a company's response to an internal whistleblower – because the investigation was initiated from the company's auditor, the company should take into account that issues leading to the investigation are by definition already known to individuals outside the company.

The analysis of whether to disclose publicly the allegations of an illegal act and subsequent investigation is usually made under a materiality standard. The broad factors to be considered in this context include: whether the accounting issues identified may result in a restatement or other material adjustment to reported financials; whether the issues could result in a civil enforcement action, criminal prosecution, or other litigation that would be material; and whether the investigation process itself may result in a delay of a company's financial statements. Even if the issues underlying the 10A inquiry are unlikely to be material, a delay in the filing of a company's financial statements will be public and may have collateral business consequences, such as breach of covenants in lending or financing instruments.

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[20] *Compare Int'l Design Concepts, Inc. v. Saks Inc.*, 05 Civ. 4754 (PKC), 2006 U.S. Dist. LEXIS 36695, *5-9 (S.D.N.Y. June 6, 2006) (disclosure of an internal report regarding possible fraud to independent auditor did not waive work-product protection); *Frank Betz Assocs., Inc. v. Jim Walter Homes, Inc.*, 226 F.R.D. 533, 533-35 (D.S.C. 2005) (same re disclosure of a litigation reserve) *and Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 445-49 (S.D.N.Y. 2004) (same re disclosure of two internal investigation reports) *with Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113, 115-17 (S.D.N.Y. 2002) (disclosure of minutes of Special Litigation Committee to independent auditor waived work-product protection because the company and auditor did not share common interest in litigation and because of auditor's "public watchdog" function) *and United States v. Mass. Inst. of Tech.*, 129 F.3d 681, 686-87 (1st Cir. 1997) (same re disclosure of minutes of meetings to an audit agency because of the potential for dispute between MIT and the agency).

Appropriate Remedial Actions

The outcome of an internal investigation initiated pursuant to Section 10A will obviously depend on the nature and scope of issues that are identified in the investigation, the personnel involved in the conduct, and the effect on a company's financial statements. The 10A statute contemplates that if the investigation identifies an illegal act or acts that have a material effect on the company's financial statements, management will take "timely and appropriate" remedial action. Such action could include personnel actions, restatement or other adjustments to prior financials, adjustments and disclosures in current financial statements, changes in accounting policies or treatments, and changes in internal structure, processes and procedures.

As a practical matter, the possibility of remedial actions being unacceptable to the auditor is greatly reduced if the auditor is kept apprised of the status of the investigation and of actions that are being considered by the company. Thus, after senior management, the board, or audit committee has received a report of the 10A investigation and has assessed potential remedial actions, a summary of the results of the investigation and the proposed actions can be shared with the auditor for discussion (with the caveat that sharing of certain information may be deemed to be a waiver of privilege). If a consensus can be reached on the remedial actions, the auditor's requirement to issue a report under Section 10A is not triggered. If the company is unable or unwilling to take action that the auditor believes is appropriate, the statutory reporting requirements come into force.

CONCLUSION

In light of recent enforcement actions against auditors and issuers, the pressures to respond appropriately under Section 10A remain strong. Familiarity with the process of investigations under the statute and careful consideration of the issues that arise during the course of an investigation are crucial to mitigating the risk of enforcement actions and to managing financial statement and disclosure issues that arise in such circumstances. ■

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