



Federal Securities Law Forum: Accountant Liability Trends & Strategies

December 7, 2023

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Accountants' Liability

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The Audit Report Generally

The Audit Report

- The Audit Report is the only statement made by the auditor.
 - The Audit Report accompanies the financial statements, but, the financial statements are the responsibility of management and are issued by the Company.
 - Auditors are not liable for the statements of the issuer.
 - The arguments surrounding whether auditors are liable for alleged misstatements in the Audit Report hinge on whether the audit report is a protected statement of opinion.

The Audit Report – AS 3101 Elements of “Report of Independent Registered Public Accounting Firm”

- The first section of the Report must contain, among other things:
 - “An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework.” AS3101.08(e)

The Audit Report – AS 3101 Elements of “Report of Independent Registered Public Accounting Firm” (con’t)

- The second section of the Report contains standard statements about the “Basis for Opinion” including:
 - “the financial statements are the responsibility of the company’s management”
 - “that the auditor’s responsibility is to express an opinion on the financial statements based on the audit”
 - “that the audit was conducted in accordance with the standards of the PCAOB”

The Audit Report – AS 3101 Elements of “Report of Independent Registered Public Accounting Firm” (con’t)

- “standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud”
- Standard statements about the audit, that it provides a reasonable basis for the auditor’s opinion
- A statement that the accounting firm is registered with the PCAOB and is required to be independent

The Audit Report – Limitations

- “Since the auditor’s opinion on the financial statements or internal control over financial reporting is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with [PCAOB] standards.” AS 1015.13.

Section 10(b) of the Exchange Act

Section 10(b)

- A showing that an auditor either lacked a genuine belief that its representations were supported by adequate information or engaged in auditing practices so shoddy that they amounted at best to a “pretended audit” has traditionally supported a finding of liability. In re Suprema Specialties, Inc. Sec. Litig., 438 F. 3d 256 (3d Cir. 2006)

New England Carpenters Guaranteed Annuity & Pension Funds v. DeCarlo, 80 F. 4th 158 (2d Cir. 2023)

- The Court underscored the materiality requirement.
- Found that the failure to adequately allege a link between the alleged misstatement in the Auditor's Opinion and the errors in the Form 10-K was fatal.
- Concluded that “general” statements in the Auditor's Opinion are not enough without detailed allegations about how the auditor's “failure to supervise, review, document and perform in good faith” its audit “would have been significant to a reasonable investor in making its investment decisions.”

Section 11 of the Securities Act

Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, (2015)

- To state a Section 11 claim against an auditor for its statement of opinion, Plaintiffs must plead either that the auditor did not “actually hold[]” its opinions at the time it consented to their incorporation by reference into the offering materials, or that the auditor omitted material facts about its inquiry into or knowledge concerning the opinion that made the opinion misleading to a reasonable investor.

Defenses to Section 11 Claims

- An auditor can avoid section 11 liability by showing it acted with due diligence (e.g., by showing that it complied with applicable accounting principles).
- Slack Technologies, LLC v. Pirani (2023), Supreme Court held that plaintiffs must plead and prove that they bought shares registered under that registration statement.

SEC Enforcement Developments

3/17/23 – Paul Munter, Chief Accountant – Responsibilities of Lead Auditors to Conduct High-Quality Audits When Involving Other Auditors

- Addressed increased use of accounting firms other than the lead auditor on issuer audit engagements.
- Munter stated that the staff observed shortcomings related to the lead auditor's performance of its responsibilities in planning, supervising, and evaluating the work performed by other auditors, including in engagements involving the use of network-member other auditors.
- A critical take-a-way is that the SEC's position is that the lead auditor's system of quality control over personnel management and supervision of the audit engagement must encompass the work of other auditors.

8/25/23 – Paul Munter, Chief Accountant – The Importance of a Comprehensive Risk Assessment by Auditors and Management

- “Management’s and auditors’ risk assessment processes are critical to the decisions regarding financial reporting and the effectiveness of internal control over financial reporting (ICFR). Accordingly, we are troubled by instances in which management and auditors appear too narrowly focused on information and risks that directly impact financial reporting, while disregarding broader, entity-level issues that may also impact financial reporting and internal controls. Such a narrow focus is detrimental to investors as it can result in material risks to the business going unaddressed and undisclosed, thereby diminishing the quality of financial information.”

- “Issues that may also impact financial reporting and internal controls often present themselves as isolated incidents across an issuer—for example, a data breach in a system not part of ICFR, a repeat non-financial reporting-related regulatory finding classified as lower risk, a misstatement to the financial statements determined to be a revision restatement (i.e., “little r”), or a counterparty risk limit breach.”

- “Finally, trust in the markets depends on gatekeepers like auditors, lawyers, underwriters, and others—gatekeepers like you. When those in positions of trust abuse that trust, we will not hesitate to hold them to account.”
- He then singled out a major accounting firm that took on a large number of Special Purpose Acquisition Company (SPAC) clients. The staff took the position that growth exposed quality control and widespread audit standard violations.

Rule 102(e)

- May be denied privilege to appear or practice is found to have engaged in “improper professional conduct”, which means:
 - Intentional or knowing conduct, or
 - Either of two types of negligent conduct:
 - Single instance of highly unreasonable conduct.
 - Repeated instances of unreasonable conduct.

- The term “repeated” may encompass as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits.

Expanded Enforcement

- Engagement Quality Review (EQR) Partner
- Firms for internal control issues
- National office partners
- Changes to confirmation process

3/29/23 – Spicer Jeffries LLP and audit engagement Partner Sean Tafaro

- According to the SEC's order, during the audit planning stages, Spicer Jeffries and Tafaro assessed that valuation of investments was a significant fraud risk but did not implement the planned audit approach to respond to the risk.
- Also claim they failed to obtain sufficient audit evidence about the method of measuring fair value, the valuation models, and whether alternative valuation assumptions were considered.
- The order also finds that Spicer Jeffries' deficient system of quality control led to failures to adhere to professional auditing standards.
- Firm agreed to censure and implement undertakings to retain an independent consultant. Tafaro suspended for one year.

- The SEC charged Marcum with systemic quality control failures and violations of audit standards in connection with audit work for hundreds of special purpose acquisition company (SPAC) clients beginning at the latest in 2020.
- According to the SEC's order, over a three-year period, Marcum more than tripled its number of public company clients, including auditing more than 400 SPAC initial public offerings in 2020 and 2021. The strain of this growth, however, exposed substantial, widespread, and pre-existing deficiencies in the firm's underlying quality control policies, procedures, and monitoring.
- Without admitting or denying the SEC's findings, Marcum agreed to pay a \$10 million penalty, to be censured, and to undertake several remedial actions, including retaining an independent consultant to review and evaluate its audit, review, and quality control policies and procedures, as well as abide by certain restrictions on accepting new audit clients.

- Between approximately December 2017 and October 2020, Prager improperly included indemnification provisions in engagement letters for more than 200 audits, reviews, and exams.
- As a result, the complaint alleges, Prager was not independent from its clients for those engagements, as required under the federal securities laws.

Watch for Increased Confirmation Cases

- The confirmation process involves an auditor selecting one or more items to be confirmed, sending a confirmation request directly to a confirming party (e.g., a financial institution), evaluating the information received, and addressing nonresponses and incomplete responses to obtain audit evidence about one or more financial statement assertions.
- New standard coming regarding use of confirmations. Historically has been hot area in many enforcement proceedings.

Take-a-ways

- Make sure engagement letters comport with securities laws, which restrict typical contractual indemnification and other similar language.
- Make sure clients are focused on internal quality controls over client acceptance and audit quality.
- In high risk areas like Crypto, Broker-dealers, SPACs know that clients' engagements are under heightened scrutiny.
- Prepare your clients on new rules regarding confirmations and clarifications on rules dealing the use of other auditors to assist engagements.

Thank you.

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