

PCAOB Enforcement Milestone

December 12, 2016

On December 5, 2016 the PCAOB announced that it had settled charges against Brazil-based Deloitte Touche Tohmatsu Auditores Independentes for a record \$8 million civil penalty. [PCAOB News Release](#). Deloitte Brazil was charged with knowingly issuing materially false audit reports for the 2010 financial statements and internal control over financial reporting of its client, a Brazilian airline. Deloitte Brazil admitted that it violated quality control standards and failed to cooperate with a PCAOB inspection and investigation, the first admissions the PCAOB has obtained from a global network firm. In addition to the \$8 million civil penalty, Deloitte Brazil agreed to sanctions, including censure, undertakings to improve the firm's system of quality control, appointment of an independent monitor, immediate practice limitations, and additional professional education and training for the firm's audit staff.

The PCAOB also announced sanctions against 12 former partners and other audit personnel of the firm, including certain firm leaders, for violations, including noncooperation with a PCAOB inspection and subsequent investigation. A former engagement partner was also charged with causing the firm to issue materially false audit reports. All but one were barred or suspended from associating with a registered public accounting firm.

The PCAOB granted significant credit for extraordinary cooperation to one individual—a senior manager on the audit—after he reported to PCAOB staff that senior firm management was obstructing the PCAOB investigation. His cooperation included (a) making himself available for extensive interviews and other consultations, during which he provided detailed information concerning events relating to the 2010 audit, the 2012 inspection, and the firm's obstruction of the PCAOB's inquiry and investigation; and (b) providing the PCAOB with multiple audio recordings that he had made of conversations with senior firm partners concerning the obstruction of the investigation, and assisting the PCAOB in understanding the context and import of the recordings. Credit was also granted to two other individuals for providing substantial assistance to the investigation under the PCAOB's "Policy Statement Regarding Credit for Extraordinary Cooperation in Connection with Board Investigations," [PCAOB Release No. 2013-003](#), Apr. 24, 2013.

The PCAOB characterized the settlement as involving "some of the most serious misconduct the PCAOB has ever uncovered." The PCAOB found that in advance of a 2012 PCAOB inspection, a Deloitte Brazil engagement partner, who also served as the firm's audit practice leader, directed junior personnel to alter work papers from the 2010 audit to conceal known audit deficiencies. The PCAOB also found that multiple firm partners provided false testimony under oath and made false representations to PCAOB staff in an attempt to obstruct the PCAOB investigation.

The charges arose out of Deloitte Brazil's 2009 and 2010 audits of a Brazilian airline, Gol Linhas Aéreas Inteligentes S.A. ("Gol"). According to the PCAOB, during the 2009 audit of Gol, Deloitte Brazil auditors concluded that Gol had failed to appropriately track its use of maintenance deposits on a contract-by-contract basis, preventing the auditors from obtaining sufficient competent evidence to support the large majority of Gol's reported 2009 maintenance deposits. The auditors acquiesced in Gol's accounting based on its representation that it intended to hire a consultant to analyze its maintenance deposit records. During 2010 Gol wrote down some of the deposits as current period expenses even though they related to prior periods, but still planned to report unsupported maintenance deposits as assets on its 2010 balance sheet. The audit engagement partner knowingly acquiesced in both the unsupported reporting of expenses and a potentially material amount of assets.

Months after issuing unqualified audit reports, certain of the auditors participated in the improper alteration of work papers from the 2010 Gol audit to create the appearance that a belatedly-discovered accounting provision had in fact been considered at the time of the audit. As admitted by Deloitte Brazil, a total of 56 work papers from the 2010 Gol audit and 14 work papers from the 2010 quarterly reviews were altered. In July 2016 the PCAOB confronted a senior partner with evidence—audio recordings made by a senior manager—of his obstruction. Deloitte Brazil subsequently admitted to failing to cooperate with the PCAOB’s 2012 inspection, by withholding the original work papers and falsely certifying that Deloitte Brazil had produced all documents responsive to the PCAOB’s demands. It also admitted to failing to maintain a system of quality control during the period of wrongdoing that provided reasonable assurance that its personnel would act with integrity.

The PCAOB action seems a milestone in many respects. It is the first time the PCAOB has charged a global network firm under Section 10(b) of the Securities Exchange Act of 1934 for issuing materially false audit reports and the first time the PCAOB has required admissions from a global network firm in a settlement agreement. The settlement involves the largest number of individuals charged (12) in one PCAOB enforcement action, and the largest penalty the PCAOB has imposed on a firm. The PCAOB also offered extraordinary cooperation credit to an individual who used his iPhone to tape conversations with senior leadership about the obstruction.

Conclusion

The PCAOB action reflects a regulatory focus on cross-border audits both on the inspection and the enforcement fronts. The Director of Enforcement of the PCAOB underscored this focus in remarks made recently at an AICPA Conference on December 7, 2016: See “Protecting Investors Through Enforcement,” <https://pcaobus.org/News/Speech/Pages/Modesti-speech-AICPA-12-7-16.aspx> (“Today, I would like to spend the bulk of my time discussing another higher priority area for DEI: investigations focusing on the risks associated with cross border audits. Our enforcement efforts over the last several years to police the cross border area have resulted this year in several settlements which are significant both for the profession and investors. . . . While an overwhelming majority of auditors play by the rules, . . . these matters demonstrate the ongoing need for a strong, robust, investigatory and disciplinary body over the profession to ensure no one acts above the law and to encourage quality audit work and high ethics. Nothing can substitute for a strong and effective cop on the beat to ensure that investors are adequately protected.”)

The PCAOB has emphasized its international focus will continue in the coming year:

- “In 2017, I expect [PCAOB Enforcement] to continue to be very active on the international front. And while I cannot specifically comment on our inventory of active investigations or on the non-public disciplinary proceedings we are litigating, I can tell you that our enforcement program continues to be very active in looking across borders. We continue to be looking closely at the roles played by the international affiliates of the global network firms in the audits of U.S. listed companies, including audits where the international affiliates may have played a substantial role. And you can expect continued growth in the level of enforcement activity involving auditors based outside the U.S., as well in our other higher priority areas.” *Id.*

Thus, audit firms involved in cross border audits, whether they be foreign audit firms or U.S. based audit firms, should expect the continued focus of the PCAOB in the coming year and beyond. If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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