

GIBSON DUNN

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Halting Movement in the U.K. Toward New Audit Regime but the U.K. Financial Reporting Council Remains Active

In the last few months, the United Kingdom has continued its efforts to implement changes to its audit regulatory scheme. Years after the initial threats of radical regulatory overhaul, it appears that the end result may be a more balanced and limited set of reforms carried out over a longer timeframe.

In the wake of prominent accounting scandals in the 2010's, the U.K. Government commissioned three separate reviews of the causes and fixes for the perceived inability of the Financial Reporting Council (FRC) to prevent such events. In December 2018, the report of the Independent Review of the FRC, also known as the [Kingman Report](#), concluded that the FRC should be replaced with a new regulator, the Audit, Reporting and Governance Authority (ARGA), with a clearer statutory mission and powers. Separately, in April 2019, the Competition and Markets Authority (CMA) published a report, "[Statutory audit services](#)

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[market study](#),” that recommended joint audits to increase the market share of non-Big Four firms, as well as an operational split in the Big Four’s audit and non-audit businesses. In December 2019, Sir Donald Brydon issued the third report, [“Report of the independent review into the quality and effectiveness of audit.”](#) The Brydon report suggested that there should be a fundamental re-defining of what the audit is, including how professional judgment and skepticism are applied, with several recommendations to bring the U.K. audit process closer to the U.S. process adopted under the Sarbanes-Oxley Act of 2002.

The U.K. Government responded to these reports with a consultation paper published by the Department for Business, Energy and Industrial Strategy (BEIS) in March 2021, [“Restoring trust in audit and corporate governance.”](#) which proposed new legislation not only to create ARGA but also to adopt new auditing principles that included strengthened obligations to detect fraud. Since that time, the FRC has been planning for its eventual replacement by ARGA and further soliciting public comment on the future powers, responsibilities, and structure of that new regulator. Most recently, the FRC’s [Three-Year Plan](#) issued in early April 2022 described the additional budgetary and staffing resources that it believed it would need as it transitioned to ARGA, and on July 12, 2022, the FRC issued a Position Paper, [“Restoring Trust in Audit and Corporate Governance.”](#) which described the FRC’s plans to revise the Corporate Governance Code and the Ethical Standard and take other steps to support the Government’s intended legislative changes.

On May 10, 2022, however, the Queen’s Speech setting out the Government’s priorities before Parliament gave little mention and short shrift to audit reform as the United Kingdom deals with other legislative priorities from Ukraine to inflation. The lack of focus suggests that ARGA—as a statutorily empowered regulator—may not come into full being until 2025 or even later. Although the Government’s May 31, 2022 [response](#) to the 2021 consultation comments, in conjunction with the FRC Position Paper, suggests that the Government intends to press forward with implementing many of the consultation paper proposals, including by giving ARGA the power to enforce an operational split between firms’ audit and non-audit businesses, and also suggests that the financial sector expects the new legislation will occur eventually, there will be many rounds of debate and further public discussion before the shape of ARGA is conclusively determined.

In the meantime, the FRC has continued to remain active on the rulemaking, inspections, and enforcement fronts. It published a new [Audit Firm Governance Code](#) on April 13, 2022 that created new requirements for the boards of audit firms; on June 22, 2022, it published a [Consultation Document](#) on 11 proposed Firm Level Audit Quality Indicators; and on June 23, 2022, it published a “first of its kind” [Professional Judgement Guidance](#) document (comprising a framework for making professional judgments and a series of illustrative examples showing the exercise of professional judgement in practice). The FRC also announced on May 27, 2022 the [key findings](#) from its most recent inspection cycle; and on June 7 assessed multi-million-pound penalties in connection with the audits of [Galliford Try plc](#) and [Kier Group plc](#).

Challenges to SEC (and Other?) Administrative Proceedings Progress

Two court orders in the second quarter raised significant questions about the SEC’s administrative hearing system; one of them, if upheld, could portend trouble for

administrative proceedings more generally.

On May 18, 2022, in *Jarkesy v. SEC*, the Fifth Circuit [ruled](#) in favor of a hedge fund founder and affiliated investment adviser who challenged the SEC's ability to institute fraud proceedings in its in-house administrative tribunal. The court ruled that (i) the ALJ hearing process violated the respondents' Seventh Amendment right to a jury trial because allegations of fraud exist at common law and are not "public rights" created by the securities laws; (ii) Congress had failed to provide an intelligible principle to the SEC concerning when to exercise its administrative proceeding authority; and (iii) ALJs are inferior officers who are unconstitutionally protected from removal by a system that requires the Merit Systems Protection Board to find good cause. On July 7, 2022, the SEC petitioned the full Fifth Circuit for rehearing en banc in an attempt to overturn the panel ruling.

Two days earlier, on May 16, 2022, the Supreme Court granted the [petition for certiorari](#) of the United States in *SEC v. Cochran* to decide whether respondents in SEC administrative proceedings can bring constitutional challenges to the ALJ removal rules. Combined with *Jarkesy*, the Supreme Court's writ portends potential upheaval in the SEC's administrative hearing system. Additionally, the Fifth Circuit's interpretation of "public rights" in *Jarkesy* could implicate other regulatory schemes whose administrative hearings address claims that exist in common law.

Commenters Weigh in on SEC's Climate Change Proposal

On May 9, 2022, the SEC extended the comment period related to its proposed rule on climate disclosures from May 20, 2022 to June 17, 2022. For a recap of the SEC's proposed rule, see Gibson Dunn's Q1 2022 Accounting Firm Quarterly Update or the Firm's [client alert](#) on the topic. The SEC's reconstituted Investor Advisory Committee also held a virtual public meeting on June 9, 2022 in which the climate disclosure proposal was a key topic.

In the meantime, hundreds of individual comment letters, in addition to several thousand form letters, have been submitted on the proposed rule. Among the prominent letters have been those from the [AICPA](#), the [Center for Audit Quality](#), [IFAC](#), [Baker Tilly LLP](#), [BDO USA LLP](#), [Crowe LLP](#), [Deloitte & Touche LLP](#), [Ernst & Young LLP](#), [Grant Thornton LLP](#), [KPMG LLP](#), [Mazars USA LLP](#), [PricewaterhouseCoopers LLP](#), and [RSM US LLP](#) as well as the [Federal Regulation of Securities Committee of the American Bar Association](#) (ABA), [Institute of Internal Auditors](#), [CalPERS](#), the [National Association of Manufacturers](#), the [U.S. Chamber of Commerce](#), and [BlackRock](#).

The letters, both those in support and those opposed to the proposal, have raised a number of issues with which the Commission will need to grapple as it considers a final rule, including:

- Whether it is appropriate for the SEC to promulgate accounting principles rather than delegating that task to the Financial Accounting Standards Board, and even if so whether the proposed principles are sufficiently clear;
- The need for the standards to govern the reporting of greenhouse gases to be consistent enough to achieve apples-to-apples comparability in disclosures, but flexible enough

to recognize the significant differences in the climate risks posed by various types of industries;

- The need for companies to adapt their internal control over financial reporting, including their disclosure controls, to account for greenhouse gas disclosures;
- The potential need for a longer implementation period, especially for small- and medium-sized businesses;
- The difficulty of assessing, especially at the outset of the reporting regime, what climate-related information is material to investors;
- Whether climate-related information should be filed or furnished with the SEC; and
- Whether firms issuing attestation reports concerning climate change disclosures should be required to be registered with the PCAOB and subject to its inspections and enforcement regimes.

Additionally, the public discussion around the SEC's proposal has made clear that, should the Commission issue a final rule, there likely will be serious legal challenges to its statutory authority to do so. We expect that the shape of climate reporting—including the scope, if any, of a third party's role in attesting to the registrant's climate reporting—will not be settled for some time to come.

ENABLERS Act Gets Fast-Tracked in the House

On June 22, 2022, the House Armed Services Committee marked up the [FY 2023 National Defense Authorization Act](#) (NDAA), and in doing so added to the bill the text of the ENABLERS Act. The ENABLERS Act, introduced as a standalone bill in October 2021, would expand the definition of “financial institution” in the Bank Secrecy Act (BSA) to include “a certified public accountant or public accounting firm,” among other added entities. The ENABLERS Act arises out of the Pandora Papers investigation and is designed to make law firms, investment advisors, art dealers, accountants, and others who may advise or transact with wealthy clients subject to anti-money laundering regulations, which would require them to, among other things, implement a risk-based anti-money laundering program, monitor for and report suspicious activity, and conduct Know Your Customer processes concerning clients.

In addition, the ENABLERS Act, as currently worded, would eliminate the discretion that the Financial Crimes Enforcement Network (FinCEN) within the Department of the Treasury currently has and has heretofore used not to apply these anti-money laundering regulatory obligations on professions listed in the BSA statute as financial institutions. That said, and assuming the FY 2023 NDAA passes with the ENABLERS Act still a part of it, FinCEN's implementing regulations would determine precisely how broadly within the accounting profession those obligations apply, and how burdensome they are. FinCEN's rulemaking process for the implementing regulations could also take years and the regulations would have an effective date several months, if not more, after their finalization, which would provide the accounting profession with time to implement any required policies and procedures.

U.S., U.K., and EU Sanctions Prohibit Accounting Services to Russia

On April 6, 2022, the United States government continued its imposition of economic sanctions in response to Russia's invasion of Ukraine when President Biden issued [Executive Order 14071](#) prohibiting new investments in Russia by U.S. persons, and also prohibiting the export or sale of any services from the United States to Russia that the Secretary of the Treasury designates. On May 8, 2022, pursuant to that authority, the Office of Foreign Assets Control issued a [Determination](#) identifying "accounting, trust and corporate formation, and management consulting" as the prohibited services, though it does not apply to services provided to an entity located in Russia that is owned or controlled by a U.S. person, nor does it prevent services related to the wind down or divestiture of a Russian entity. The prohibition went into effect on June 7, 2022. Additionally, [General License 35](#) authorizes certain transactions related to the export or sale of credit rating or auditing services through August 19, 2022.

In parallel, the U.K. Foreign Ministry [announced](#) on May 4, 2022, its own ban on the export of consulting, accountancy, and public relations services to Russia. The announcement occurred in connection with 63 additional sanctions imposed on figures in Russian technology and media. Additionally, on June 3, 2022, the European Union [adopted](#) a sixth package of sanctions against Russia. Newly inserted Article 5n of Regulation (EU) No. 833/2014 (as amended) prohibits, directly or indirectly, providing accounting, auditing (including statutory audit), bookkeeping, tax consulting, business or management consulting, or public relations services to (i) the Government of Russia, or (ii) legal persons, entities, or bodies established in Russia.

The full scope of the bans on accounting services remains to be seen, including to what extent each government will police the provision of "in-house" services to subsidiaries and joint ventures. At a minimum, they would appear to limit U.S., U.K., or EU auditors from directly performing audit work for Russian issuers and subsidiaries—eliminating one potential way in which the profession might have addressed the previously announced separation of the Russian members of major international accounting networks. The ban does not prevent the reliance of U.S., U.K., or EU auditors on audit work performed in Russia as part of a cross-border audit engagement, but auditors with client operations in Russia will need to consider carefully how to structure the work on their engagements.

Supreme Court Upholds Arbitrability of Individual PAGA Claims

On June 15, 2022, the U.S. Supreme Court issued [Viking River Cruises, Inc. v. Moriana](#), holding that the Federal Arbitration Act (FAA) preempts a California rule prohibiting parties from agreeing to arbitrate Private Attorneys General Act (PAGA) claims on an individual basis. PAGA enables California employees to bring claims not only on their own behalf but also on behalf of other employees. In an opinion joined in full by four other justices and in part by three more (with only Justice Thomas fully dissenting), Justice Alito wrote that, when an employee has agreed to individually arbitrate their PAGA claims, the FAA requires courts to enforce that agreement. The Court also held that, under existing California law, that employee would lack standing to bring representative PAGA claims on behalf of other employees. However, in a concurring opinion, Justice Sotomayor raised the possibility of further interpretations by the California courts or further action by the legislature that could re-open the door for representative claims, so the future of class claims in California remains unclear. As a result, the ultimate effect of the Court's decision is still to be determined.

Gibson Dunn has issued a [client alert](#) concerning the ruling.

Germany Proposes Whistleblower Law and Permits Hague Convention Pre-Trial Discovery

On April 13, 2022, Germany's Ministry of Justice published a [draft Whistleblower Protection Act](#). If enacted, the bill would implement [EU Directive 2019/1937](#), which established minimum standards of protection for persons reporting violations of EU law, thereby bringing Germany back into EU compliance after it missed the transposition deadline in December 2021. The draft bill goes further, however—in addition to violations of EU law, it would protect whistleblowers who report violations of German criminal law, as well as violations of regulatory laws that carry financial penalties and relate to life, health, or employee rights.

The comment period for the Ministry of Justice draft closed in May 2022, but it remains to be seen how the German government will address the numerous (and often negative) comments received and the more noted aspects of its draft, including concerns regarding whether the bill adequately prioritizes internal reporting through company channels over external reporting and the potential risks of misuse. The revised bill may also resolve an ongoing dispute among EU member states regarding whether company subsidiaries can rely on centralized or corporate-level reporting systems to satisfy the law; the German government suggested that such reliance would be permissible, though the law did not explicitly establish that.

Two Gibson Dunn attorneys recently published a German-language [article](#) in *Betriebs-Berater* concerning the EU Directive as a whole.

Separately, on May 19, 2022, the German government amended its legislation implementing the Hague Evidence Convention to permit pre-trial discovery. As Gibson Dunn's [client alert](#) discussed, however, the act still contains certain limitations that could restrain the gathering of pre-trial evidence in Germany.

Other Recent SEC and PCAOB Regulatory Developments

Rulemaking

- On June 21, 2022, the PCAOB [adopted](#) a package of auditing standard changes that could significantly modify the manner in which lead auditors on a multi-location audit are required to oversee the work of other auditors performing referred or component work. The headline change in this package was that the PCAOB would rescind AS 1205, *Part of the Audit Performed by Independent Auditors*, and move the procedures that apply to multi-location oversight into AS 1201, *Supervision of the Audit Engagement*. This change would bring the procedures applicable to oversight of other auditors closer to those applicable to an engagement partner's oversight of the core audit team, though the specific procedures would continue to be distinct. The new standards await SEC approval.
- On May 4, 2022, the PCAOB updated its [standard setting and research agenda](#). In addition to the adoption of the other auditor standard, the PCAOB projected in that 2022 it would issue proposed new standards on firm quality control systems, noncompliance with laws and regulations, and attestation standards, with standards on going concern and confirmations following in 2023.
- The PCAOB also [requested comment](#) on April 12, 2022, concerning its recently adopted standards on accounting estimates and the use of specialists as part of a post-implementation review of those standards.

Enforcement Actions

- On April 5, 2022, the PCAOB issued a [settled order](#) imposing a \$100,000 penalty on Scott

Marcello, the former Vice Chair of Audit at KPMG US, in connection with KPMG personnel obtaining internal PCAOB inspection information. The order is notable for at least two reasons. First, it is the first instance in which the PCAOB has held an individual liable under PCAOB Rule 5200(a)(2) for failure to supervise primary violators. Second, it comes almost exactly five years after the matter became public, and likely represents a final coda on the discipline imposed on KPMG and individuals from the firm and the PCAOB, discipline that has included criminal convictions and SEC enforcement actions.

- On June 28, 2022, the SEC continued the trend of regulatory focus on conduct by auditors in their CPE and licensing training and examinations by [sanctioning](#) EY's US firm \$100 million for alleged misconduct by firm personnel in CPE and licensing examinations, as well as for EY's alleged failure to timely report the conduct to the SEC after earlier receiving a related inquiry. Dissenting from the imposition of the penalty, Commissioner Peirce issued a [statement](#) taking issue with the allegations concerning EY's actions in response to the SEC inquiry, suggesting that the SEC was attempting to establish a duty by investigated parties to correct prior responses to a voluntary inquiry when later facts emerge.
- Other recent enforcement actions:
 - On April 18, 2022, the SEC issued a [settled order](#) charging Rollins, Inc., and its former CFO for using inappropriate reductions in reserves to meet consensus analyst EPS estimates in two quarters in 2016 and 2017.
 - On April 19, 2022, the PCAOB issued two settled orders charging U.S.-based firms in connection with work in China by unregistered firms. In the [first](#) matter, the U.S. firm allowed an unregistered affiliate firm in Hong Kong to play a substantial role in numerous audit engagements. As with the Marcello matter above, the PCAOB charged the firm with a failure to supervise the Hong Kong firm, which the PCAOB alleged was an associated person of the U.S. firm. In the [second](#) matter, the PCAOB sanctioned a firm for signing audit reports where substantially all of the work was performed by an unregistered firm in China.
 - On June 7, 2022, the SEC issued [settled orders](#) charging Synchronoss Technologies, Inc., and five current or former Synchronoss employees for having improperly recognized revenue in connection with certain transactions and acquisition and divestiture activity between 2013 and 2017. The SEC also obtained a [SOX 304 clawback order](#) from the company's former CEO. The SEC actions came about four years after Synchronoss's restatement and about seven months after a parallel PCAOB [settled order](#) against the engagement partners on the Synchronoss audits.
 - On June 8, 2022, the SEC issued [settled orders](#) charging CohnReznick and three of its partners with audit failures in connection with its audits of two issuers.
 - On June 8, 2022, the SEC [sanctioned](#) the partner and manager on the audit of a company in the healthcare industry for multiple PCAOB standards failures in the face of two fraudulent transactions by the company.

Other Regulatory Developments

- On May 9, 2022, the PCAOB [announced](#) the membership of its newly constituted Investor Advisory Group and Standards and Emerging Issues Advisory Group. The two groups held their first meetings on June 8 and June 15, 2022, respectively; both meetings focused on providing the members with an overview of the PCAOB and the Board's strategic plan.
- On May 17, 2022, SEC Chair Gensler [testified](#) before the House Appropriations Subcommittee

on Financial Services and General Government in support of the SEC's FY 2023 budget request of \$2.149 billion, an 8 percent increase over FY 2022. The request envisions a 6 percent increase in staffing, including additional Enforcement personnel for hotline tips and the Crypto Assets and Cyber Unit. Chair Gensler's testimony noted that the SEC "expect[s] the number of litigated cases to continue to rise as Enforcement increasingly holds wrongdoers accountable with meaningful and, in some instances, escalating sanctions."

- On June 8, 2022, SEC Acting Chief Accountant Paul Munter issued a statement, "[The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession](#)," emphasizing that the general independence standard set out in Rule 2-01(b) of Regulation S-X is the "heart" of the auditor independence rules, and that compliance with the enumerated items in Rule 2-01(c) is necessary but not sufficient to meet the 2-01(b) standard. Munter's statement also described the SEC Staff's consultation process for accounting firms with auditor independence questions. Munter made further comments about the consultation process at an American Law Institute conference on accountants' liability on June 9, 2022.

For further information about any of the topics discussed herein, please contact one of the Accounting Firm Advisory and Defense Practice Group Chairs, or the Gibson Dunn attorney with whom you regularly work.