WHISTLEBLOWER AWARDS FOR INDEPENDENT AUDITORS

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By
Frederick D. Lipman*

Did you know that partners, principals, managers and other employees of your independent auditing firm may, under certain circumstances, be entitled to a **whistleblower reward** under the SEC rules which are effective August 12, 2011? I suspect this will be a surprise to most compliance professionals, CFOs and their audit committees.

As you are all probably aware, SEC whistleblowers are entitled to a mandatory bounty equal to a minimum of 10% and a maximum of 30% of what has been collected of the monetary sanctions imposed in any covered judicial or administrative action or related action. The SEC whistleblower rules were adopted pursuant to the Dodd Frank Wall Street Reform and Consumer Protection Act enacted July 11, 2010.

Although the general rule is that an employee or other person associated within a public accounting firm cannot obtain a whistleblower award if the information was obtained through the performance of an engagement "required" of an independent public accountant under the federal securities law, there are **four exceptions** which will permit partners, principals, managers and other employees of independent auditing firms (an "auditor whistleblower") to earn a whistleblower award. These four exceptions are as follows:

1. The first exception applies when the auditor whistleblower has a reasonable basis to believe that disclosure of the information to the SEC is necessary to prevent the company from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors. In order for an auditor whistleblower to claim a reasonable brief that disclosure of information to the SEC is necessary to prevent the company from committing substantial harm, the SEC expects that in most cases the auditor whistleblower will need to demonstrate that reasonable management or governance personnel at the company were aware of the imminent violation and were not taking steps to prevent it. In short, the auditor whistleblower must have a reasonable basis for believing that the company is about to engage in conduct that is likely to cause substantial injury to the financial interests of the company or investors, and that notification to the SEC is necessary to prevent the company from engaging in that conduct.

2. The second exception applies when the auditor whistleblower has a reasonable basis to believe that the company is engaging in conduct that will impede an investigation of misconduct. Thus, for example, an auditor whistleblower may be entitled to an award if he or she has a reasonable basis to believe that the company is destroying documents, improperly influencing witnesses, or engaging in other improper conduct that may hinder the SEC investigation.

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* Frederick D. Lipman is a partner with the international law firm of Blank Rome LLP and is also the President of the Association of Audit Committee Members, Inc., a non-profit association devoted to developing best practices for audit committees. He has been quoted in The Wall Street Journal, USA Today, Forbes and other business publications and is the author of the forthcoming book entitled "Whistleblowers: Incentives, Disincentives and Protection Strategies" (John Wiley & Sons, Inc. 2012).

3. Under the third exception, an auditor whistleblower can become entitled to an award after at least 120 days have elapsed since the whistleblower provided the information to the audit committee, chief legal officer, or chief compliance officer (or their equivalents) of the company at which the violation occurred, or to his or her supervisor, or since the whistleblower received the information, if he or she received it under circumstances indicating that the company's audit committee, chief legal officer, chief compliance officer (or their equivalents), or his or her supervisor was already aware of the information. The SEC has stated that the 120 days is not intended as an implicit "deadline" for an investigation by the audit committee or others. The SEC may, even after receiving the whistleblower disclosure, agree to await further results of internal investigations before beginning its own investigation.

4. An auditor whistleblower can make a submission alleging that his or her own auditing firm violated Section 10A of the 1934 Act (dealing with auditor discovery of illegal acts) or other professional standards. For example, an auditor whistleblower can allege violations of auditor independence standards or quality control standards not specific to any particular audit, or possibly even insider trading.

One can argue that there is even a fifth exception since the disqualification of the audit whistleblower from receiving an award is only limited to information obtained "through the performance of an engagement required of an independent public accountant under the federal securities laws…" For example, information obtained in an agreed procedures engagement by the auditor or tax planning could be used to obtain a whistleblower award. The SEC has indicated that the auditor whistleblower would be disqualified from the award for information obtained in the course of a quarterly financial review, as well as the annual audit process, since the quarterly review is considered as a step in the annual audit process, and therefore is viewed as "required' by federal securities laws. Auditor whistleblowers are disqualified from awards if their whistleblower submission would be contrary to the requirements of Section 10A of the 1934 Act which mandates up the corporate ladder reporting of illegal acts before disclosure is made to the SEC.

CFO's and audit committees should be asking independent auditing firms what internal procedures that firm has to deal with auditor whistleblowers. The SEC rejected the suggestion of commenters to prohibit rewards to auditor whistleblowers who breach state-law confidentiality requirements applicable to auditors on the ground that "to do so would inhibit important federal law enforcement interests". The SEC rules also provide that "No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement…" Accordingly, confidentiality agreements with the personnel of auditing firms are not enforceable, in the opinion of the SEC.

Perhaps, the next engagement letter with your independent auditing firm should provide for indemnification of the company by the auditing firm for whistleblower claims by its partners, principals, managers or other employees (based on information acquired during the audit) which are either (a) frivolous or (b) not brought to the attention of the CFO or the audit committee not later than simultaneously with their submission to the SEC. Independent auditing firms may resist this change to the engagement letter on the ground that whistleblower complaints may be made anonymously and that they should not be legally responsible for the actions of their

partners, principals, managers or other employees. This issue involves an allocation of risk and one would hope that the independently auditing firms would take responsibility for the actions of their own personnel.

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