

*re:*The Auditors

Ripped from the Headlines: Professionalism and professional skepticism in the Big 4



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## Auditors and Accounting In The News

Keynote Address: American Law Institute Conference on Accountants' Liability  
2016: [Confronting Enforcement and Litigation Risks](#)

Andrew Ceresney, Director, SEC Division of Enforcement, Washington, D.C.  
Sept. 22, 2016

- And, as the Supreme Court noted more than 30 years ago in *Arthur Young*, auditors play a crucial role in the financial reporting process by serving a “**public watchdog function**” that demands “**total independence from the client at all times and requires complete fidelity to the public trust.**”<sup>[4]</sup>
- **Auditors need to exercise appropriate professional skepticism, gather sufficient appropriate audit evidence, adequately document work, and, particularly when there are red flags, require more sufficient evidential matter than representations from management.**
- Auditors perform a key role in providing a check on management’s financial reporting and they must perform that role with a **skeptical eye and appropriate objectivity.**

## Auditors and Accounting in the News

### *Professionalism*

- *The concept of public duty*

Supreme Court's *Arthur Young* decision says auditors play a crucial role in the financial reporting process by serving a "public watchdog function."

However, "The rapid rise in the growth of non-audit services has increased the economic incentives for the auditor to preserve a relationship with the audit client, thereby increasing the risk that the auditor will be less inclined to be objective." October 12, 2001 SEC Final Auditor Independence Rules.

- *A licensed profession*

There's been a steady drive towards more "professionalization" of audit/accounting, to make it more like law. The MAcc approach created to meet the move to a 150 hours vs 120 hour requirement for the CPA exam, makes CPA a job that requires an extended course of specialized study like law or medicine, a "[learned](#)" profession, that is often automatically considered exempt from overtime.

## Auditors and Accounting in the News

- Professionalism lost
  - Insider trading
  - Cheating on inspections
  - Backdating documents
  - Rolling over on interpretation of accounting standards,
  - Stealth restatements
  - No going concern warnings
- Professionalism sold
  - Lack of auditor independence via consulting engagements (prohibited services, lobbying, foreclosure reviews, NYDFS sanctions, system integrations blow-ups)
  - Tax avoidance (Panama Papers/Lux Leaks/Paradise Papers) and evasion
  - Compromised business alliances

## Auditors and Accounting in the News

### *Professional Skepticism*

- *PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence, and it is essential to the performance of effective audits under Board standards.*

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## Auditors and Accounting in the News

### *The KPMG/PCAOB inspection data scandal*

- A grand jury indictment unsealed Jan 22 by the U.S. Department of Justice charges five former KPMG audit executives and one former professional at its regulator, the Public Company Accounting Oversight Board, with conspiracy and wire fraud, alleging they repeatedly used stolen confidential regulator information to subvert KPMG's regulatory inspection process.
- The DOJ complaint suggests, however, that at least five more unnamed KPMG partners and one outside consultant either knew or chose to ignore the illegal source of the information. The fifth unnamed partner was a whistleblower.
- The DOJ and SEC allege three KPMG partners lured three PCAOB employees — Brian Sweet, Cynthia Holder and Jeffrey Wada, all certified public accountants — into the conspiracy with promises of jobs at KPMG in exchange for stolen information. Sweet and Holder were later hired by KPMG; Wada remained at the PCAOB.
- Once at KPMG, Sweet's and Holder's jobs were then threatened if they did not continue to provide information.
- The SEC said David Middendorf, KPMG's then-national managing partner for audit quality and professional practice, Thomas Whittle, KPMG's then-national partner-in-charge for inspections and David Britt, KPMG's banking and capital markets group co-leader — encouraged Sweet to divulge stolen information to them and others at the firm.

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## Auditors and Accounting in the News

### *The KPMG/PCAOB inspection data scandal*

- The conspiracy to steal the regulatory inspection data lasted from 2015 and 2017, according to the charges. It was not a one-off occurrence.
- This is corruption at the top of the firm, in the function which is supposed to ensure quality and integrity of the audits on behalf of the client, shareholders, and the public.
- This is corruption at the PCAOB, the regulator that is supposed to be “watching the watcher.”
- DOJ and SEC imply even more people at KPMG were aware the data was stolen, but leave open the question whether the same thing occurred at more firms with more data stolen from PCAOB. A consulting firm that was implicated is also left unnamed.
  - [KPMG indictment suggests many who weren't charged knew regulator data was stolen](#)
- The DOJ and SEC leave open the question of whether KPMG will be charged as a firm.
- The DOJ and SEC leave open the question of whether the head of the audit practice, who was also fired last April because the firm said he knew about the stolen data and used it, will ever be charged.

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## Auditors and Accounting in the News

### *The KPMG/PCAOB inspection data scandal*

- The names of the clients whose audits were reviewed and revised based on the stolen data were not disclosed by the SEC, the PCAOB or the firm. We do not know if KPMG told the clients' audit committees or moved any of the partners who revised workpapers based on advance notice and stolen PCAOB data off their engagements.
- The SEC said, despite the situation, it had determined that the companies could continue to rely on KPMG and investors could continue to rely on the audits. Why do you think they made this decision?
- [Why Ambac was one of the KPMG clients that got a second look after inspection tip-off](#)
- "...the Issuer-2 re-review identified a significant error in the way the 2015 audit had been performed. According to the indictment, KPMG had failed to obtain required information from one of Issuer-2's third-party vendors concerning that vendor's own internal controls. As a result, **the KPMG partner responsible for this audit decided to withdraw the previously issued KPMG opinion included in the company's 10-K that had already been filed with the SEC**, according to the indictment."
- Based on my reporting I think my story was a surprise to Ambac. I doubt KPMG told them why they went back to their audit after issuance of the annual report, withdrew their opinion and I wonder if they changed the partner as a result. The 2016 Ambac partner still works at KPMG.

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## Auditors and Accounting in the News

### *The KPMG/PCAOB inspection data scandal*

This is third strike for KPMG

- Tax Shelter fraud 2005
- Scott London, Southwest region assurance partner in charge inside trading conviction
- In addition to significant audit failures... New Century, Countrywide, Citi, Wells Fargo, Fifa, Deutsche bank, HSBC, Carillion...
- This is not only recent example of systemic corruption at highest firm level at KPMG or other Big 4 firm
  - PwC Satyam
  - Deloitte Brazil leadership partners who blocked the PCAOB and faked documents for an audit of the airline Gol. One of those partners Wanderley Olivetti was on the Brazil side of Parmalat audit and suspected fraud. At that time he tried to do the right thing but was blocked by his own firm. He survived and then perpetuated that corrupt approach for years, passing it on to everyone who worked for him or with him.
  - Deloitte Mexico partners who did similar things as Brazil partners
  - Former partner PricewaterhouseCoopers Auditores Independentes in Brazil sanctioned for audit failures and violations of PCAOB rules and standards.
    - Wander Rodrigues Teles was the lead partner for PwC Brazil's 2010 and 2011 audit work on the Brazilian subsidiaries of Sara Lee Corporation, including Sara Lee Cafés do Brasil Ltda.
  - KPMG firm in South Africa is under investigation for allegedly colluding with corrupt politician
  - KPMG Netherlands tax fraud criminal investigation
    - [Dutch head of KPMG resigns amid criminal investigation](#)

## Auditors and Accounting in the News

### *PwC's Trials and Tribulations*

*What's the status?*

[PwC faces 3 major trials that threaten its business](#)

**TBW Trustee v. PwC:** Settled August 2016 for non-disclosed amount mid-trial. Original claim \$5.5 billion.

**MF Global Trustee v PwC:** Settled March 2017 for non-disclosed amount mid-trial. PwC settled another lawsuit by MF Global investors for \$65 million in 2015. Original claim \$3 billion.

## Auditors and Accounting In The News

- **FDIC v. PricewaterhouseCoopers LLP**, re: Colonial Bank Group failure  
Original claim \$1 billion
- On December 28, 2017, after a bench trial, U.S. District Judge Barbara Jacobs Rothstein decided that PwC was negligent in connection with one of the biggest bank failures of the financial crisis opening up the Big Four accounting firm up to \$1.4 billion in damages.
- The judge said PwC violated auditing rules and didn't take steps that could have detected a \$2 billion fraud scheme that contributed to the 2009 failure of Alabama's Colonial Bank. The decision could finally put auditors on the hook for detecting fraud
- The Big 4 have traditionally argued audits are not designed to detect fraud. The judge found PwC liable for professional negligence, the FDIC's most serious against PwC related to audits of Colonial for 2002 through 2005 and again in 2008.
- What about 2006 and 2007? A jury trial is pending because the PwC partner neglected to put a "waiver of a jury trial" clause in those two years' engagement letters.

## PwC, CBG, Auditor Independence

- During the PwC-TBW trial former SEC Chief Accountant and witness for the plaintiffs Lynn Turner told the jury that PwC had violated auditor independence standards after one of the PwC senior managers, T. Brent Hicks, was hired by Colonial in a top financial oversight position.
- Turner testified that as a result, PwC was not independent in 2005 and 2006. PwC tried to suppress Turner's testimony, but the court denied the motion.
- Where is T. Brent Hicks, the former Colonial accounting chief and PwC audit team member, now? He is currently the Senior Vice President at BB&T Bank, another PwC audit client.
- The court also determined pre-trial that PwC was not independent, "as a matter of law," for 2004 because a contract between PwC and a Colonial subsidiary included prohibited indemnification language, a violation of SEC rules.
- Finally, after PwC objected, the judge prevented testimony about a third potential independence violation for the 2008 audit.
- The SEC and PCAOB have never publicly acknowledged an investigation of these alleged independence violations.

## Auditors and Accounting In The News

### Auditor Independence Regulatory Actions

- Mary Jo White, appointed SEC Chair by Barack Obama in April of 2013, brought a renewed focus on auditor independence with enforcement actions against “gatekeepers” that enabled corporate fraud.
- In January of 2014 [the Securities and Exchange Commission announced](#) an \$8.2 million settlement with KPMG over other violations of auditor-independence rules. The SEC said KPMG had loaned staff to multiple public company audit clients from at least 2007 through 2011. That’s prohibited by SEC rules.
- The SEC then went on a bit of a tear, compared to its lack of activity in the immediate post-Sarbanes-Oxley era.
  - On July 14, 2014, Ernst & Young was sanctioned by the SEC for lobbying on behalf of two of its audit clients.
  - In July of 2015, the SEC announced a \$1 million settlement with Deloitte & Touche LLP for violations of auditor independence rules.
  - In September of 2016, the SEC fined EY \$9.3 million to settle charges it violated pre-SOX independence rules when two of the firm’s audit partners got too close to their clients on a personal level.
  - The PCAOB publicized sixteen cases involving auditor independence during 2016, most alleging audit firms had prepared financial statements or accounting records for a client.

## Independence and Objectivity

### Independence and Objectivity

That regulatory push must have gotten scary...

**Pro-Market Blog posts: My deliverable as a [Journalist in Residence](#) at the [Stigler Center](#) at the University of Chicago Booth School of Business.**

[How the Global Audit Firms, Led by Deloitte, Are Using Their Lobbying Clout to Dilute Sarbanes-Oxley Reforms](#), is about the firms’ latest attempt to “modernize” auditor independence rules.

- “While congressional Republicans, bank executives, and conservative Washington D.C. think tanks work to dismantle the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Big Four global audit firms—Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers—are using their considerable clout to dilute the reform law that changed their business more: the Sarbanes-Oxley Act of 2002.
- A look at the Big Four’s congressional lobbying activity during the first quarter of 2017 shows the auditors and the AICPA, their trade association, taking advantage of the “Trump” window to roll back Sarbanes-Oxley reforms. The industry is targeting the strict SOX auditor independence rules and the authority of the Public Company Accounting Oversight Board, the industry regulator established after Enron and its auditor, Arthur Andersen, collapsed.
- The Big Four firms are now opportunistically lobbying to go back in time, before Enron, when the industry was self-regulated and mostly left alone.”

## Auditors and Accounting In The News

### Whistleblowing

#### Can internal and external auditors be Dodd-Frank whistleblowers?

- An auditor (or any internal or external accountant) may disclose information to the SEC and be eligible for an award if:
  - the auditor has a reasonable basis to believe that disclosure of the information to the SEC is necessary to prevent the engagement client from engaging in conduct likely to cause substantial injury to the financial interest of the entity or investors;
  - the individual has a reasonable basis to believe that the relevant entity is engaging in conduct to obstruct an internal or SEC investigation; or
  - at least 120 days have elapsed since the auditor (a) provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or supervisor, or (b) received the information, if the auditor received it under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer or supervisor was already aware of the information.

<http://www.accountingtoday.com/news/audit-accounting/whistleblower-protections-and-incentives-for-auditors-and-accountants-78018-1.htm>

<https://www.propublica.org/article/the-whistleblowers-tale-how-an-accountant-took-on-halliburton>

## Auditors and Accounting In The News

### Whistleblowing

Why are accountants and auditors rarely ever whistleblowers?

- Our judgmental, rigid, black and white morality squashes skepticism. Our minds are made up to soon.
- We socialized to be team players, followers not leaders
- We are reluctant to be an "outlier", ostracized for unpopular or uncomfortable views. We are often socialized to be "pleasers."
- The lack of diversity in our ranks can breed in-group bias.
- Our undergraduate education often lacks emphasis on independent, critical thinking skills.
- We are taught form over content (What did we do last year? If it's not on the form or checklist we can't or shouldn't do it. Must stay within time and money budget.)
- Firm recruiting focuses on "fit", trainability, willingness to conform for future rewards, and respect for authority and precedent.
- We are often uncomfortable with change and the uncertainty that arises from questioning longstanding values and tenets of a profession, a firm, our colleagues, our superiors.
- We are socialized to put career and financial security before public duty, common good, greater good.



## Auditors and Accounting in the News

How to maintain professionalism and skepticism:

- Don't be a "pleaser" or hang around them.
- That's the relentless overachiever, the submissive follower, and the hero worshipper of a teacher or a prospective boss or firm. It's the person who avoids conflict and confrontation at all costs.
- They will get you into trouble, or you will talk yourself into trouble, rationalize wrong action, because you aren't able to stand up for yourself or the right thing.
- Professors can help students be more resilient by coaching independent critical thinking and the establishment of multiple career and life options.
- Students should strive to control their own destiny, in spite of parents' wishes, girlfriend or boyfriend issues, or the firm they choose.
- I will be your "phone a friend" if there is no one else.

## Auditors and Accounting In The News

**Some good books to read:**

- No individual prosecutions during crisis – Jesse Eisinger's *The Chickenshit Club* has a great chapter why everyone uses Arthur Andersen as an excuse for not indicting firms or high ranking executives.
- Jim Peterson's book second edition, *Count Down: The Past, Present and Uncertain Future of the Big Four Accounting Firms*, is great for understanding the background, the law, and the history of the profession and impact on why things are they way they are today.

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