

AUDITOR INDEPENDENCE,  
PROFESSIONAL SKEPTICISM, AND  
AUDITORS' OBLIGATIONS WHEN  
FRAUD HAPPENS:  
CASE STUDIES AND EXAMPLES

PICPA EDUCATORS CONFERENCE  
PRESENTED BY  
FRANCINE MCKENNA

JULY 19, 2013

*re:*The Auditors

# AGENDA

- Morning Keynote: The Ethics of Auditor Independence and an Auditor's Public Duty
  - The Auditor's Public Duty
  - A Review of Auditor Independence Including Some Less Often Discussed Provisions
  - Professional Skepticism
  - Recent Data
  - Updates
- Lunch Address: Auditor Independence, Skepticism, and Fraud: Case Studies and Examples
  - A Review of Professional Skepticism In The Standards and In Regulator Comments
  - The Auditors' Obligations Regarding Fraud and Other Illegal Acts
  - Case Studies
  - Resources

## MORNING KEYNOTE

- The Ethics of Auditor Independence and An Auditor's Public Duty

## AN AUDITOR'S PUBLIC DUTY

**The auditor's client is the shareholder and investor in the company, not the company's management.**

- ...By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes **a public responsibility transcending any employment relationship with the client**. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times, and requires **complete fidelity to the public trust**...United States v. Arthur Young & Co., 465 U.S. 805 (1984) [U.S. Supreme Court](#)

## PROFESSIONALISM

Keep telling yourself: **I'm a professional!** We are always hearing these days about how law has become a business. Becoming a partner leads to even greater exposure to the business side of private practice, from preparing bills to generating new clients, all of which are very important to keeping the “lights on” in the office, so to speak. But, the last time I checked, lawyers were not MBAs ...

We are part of an honorable tradition that counsels and guides the uninitiated, our clients, through what can seem like a morass of confusing laws and regulations. We are trusted to regulate ourselves and also keep the “pipes clean,” by questioning and challenging the processes and guidelines that define how disputes are resolved, all with the goal of making them as transparent and fair as possible. We are more than hired guns— even when our clients tell us otherwise...

Legal Times By Brian Corcoran [Letter to a New Partner](#)

# CHALLENGES TO PROFESSIONALISM

- The largest four firms have reported for fiscal 2012, approximately \$109 billion in revenue worldwide and counted between 150,000 and 200,000 employees and partners each on a worldwide basis.
- Auditors are paid by the companies they audit, like ratings agencies are paid by bond issuers.
- By comparison, an October survey by [American Lawyer](#) of the top 100 global law firms published revenues, even for the top ten that were much more modest. The combined revenues of the top fifty global law firms, \$55 billion, equals about half of what the largest four global audit firms report. The combined revenues of the top ten largest global law firms, approximately \$20 billion, are still less than the reported revenues of the smallest of the global audit firm, KPMG.

# PROFESSIONALISM LOST

- Insider Trading By Public Accounting Firm Professionals
  - Client confidentiality breach compounded by, perhaps, violation of financial interest rules
- Auditors/Audit Engagements
  - Scott London KPMG - Tipper
  - Tom Flanagan Deloitte – Tipper and Trader
- Other Firm Professionals
  - James Gansman EY - Tipper
  - Arnie McClellan Deloitte – Inadvertent Tipper
  - PwC Transaction Services Staff - Traders

## PROFESSIONALISM SOLD

Audit firm leadership denies responsibility for the serious legal and ethical transgressions of very senior partners by characterizing them as “rogues”.

- Tom Flanagan was a Deloitte Vice Chairman.
  - Deloitte lost no clients, endured no fines or sanctions for, by their admission, hundreds of breaches of their policies and procedures by a 38-year veteran of the firm in a leadership position that had responsibility for relationships with prestigious Fortune 500 clients.
  - Deloitte escaped criticism and sanctions because they claim this Vice Chairman “duped” the firm.
- Scott London of KPMG was a partner in charge of audit for Southern California responsible for all the audits in the region, hundreds of partners and thousands of staff.

# AUDITOR INDEPENDENCE

## The Independence Standard

([SEC Final Rule 10/12/01](#))

“Independence generally is understood to refer to **a mental state of objectivity and lack of bias**. The amendments retain this understanding of independence and provide a standard for ascertaining whether the auditor has the requisite **state of mind**.

The first prong of the standard is **direct evidence of the auditor's mental state: independence "in fact."** The second prong recognizes that **generally mental states can be assessed only through observation of external facts**; it thus provides that an auditor is not independent if **a reasonable investor**, with **knowledge of all relevant facts** and circumstances, would conclude that the **auditor is not capable of exercising objective and impartial judgment.** “

# AUDITOR INDEPENDENCE

- AICPA Auditor Independence
- Section 201 Sarbanes-Oxley Act
  - Prohibited services
  - Audit Committee pre-approval
  - Additional disclosures
  - Permitted non-audit tax services
  - Audit partner rotation
  - Audit partner compensation
  - Auditor/Client revolving door
  - Auditor/Audit Committee communication

An AICPA/SEC Independence Rule Comparison

# AUDITOR INDEPENDENCE

## ***These AICPA Independence Interpretations of Rule 101 have no specific corresponding SEC rules:***

- **Interpretation 101-4** – *Honorary directorships and trusteeships of not-for-profit organization.*
- **Interpretation 101-6** – ***The effect of actual or threatened litigation on independence***
- **Interpretation 101-10** – *The effect on independence of relationships with entities included in the governmental financial*
- *Relationships.*  
**Interpretation 101-11** – *Modified application of Rule 101 for certain engagements to issue restricted-use reports under the*
- *Statements on Standards for Attestation Engagements.*  
**Interpretation 101-14** – *The effect of alternative practice structures on the applicability of independence rules.*

# AUDITOR INDEPENDENCE

- Section 201 Sarbanes-Oxley Act
  - Prohibited Services (Internal audit, systems design and implementation, bookkeeping, etc.)
  - Audit Committee Pre-approval
  - Additional Disclosures
  - Permitted Non-audit Tax Services
    - KPMG GE
    - EY and HP, News Corp, Walmart
    - EY UK on country-by-country reporting
    - EY tax lobbying for audit clients
  - Audit partner rotation
    - 7/2 to 5/5 plus concurring partner)
    - Reality – Scott London & Skechers
  - Audit partner compensation
  - Auditor/Client revolving door
  - Auditor/Audit Committee Communication

# AUDITOR INDEPENDENCE

## Section 201 other topics

Perception versus reality of roles, no oversight, audit takes a back seat. *“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 Rules.

- Deloitte Standard Chartered ban
- Deloitte JPM Foreclosure Reviews
- PwC Ally/ResCap foreclosure reviews
- Deloitte Marin County SAP implementation
- Deloitte Kabul Bank
- KPMG due diligence HP acquisition of Autonomy
- KPMG, EY due diligence CAT acquisition of ERA, Chinese company
- PwC Thomson Reuters tax software alliance
- EY tax lobbying for audit clients
- Auditors and corporate investigations (EY Lehman case)

# AUDITOR INDEPENDENCE

## Business Alliances

- Rule 2-01 (b) of Regulation S-X (17 CFR 210.2-01.), amended under SOx to enhance auditor independence after the Enron/Arthur Andersen, provides the standard used to judge a business relationship between a company and its auditor or services provided to an audit client:
  - Does the relationship create a mutual or conflicting interest between the accountant and the audit client?
- Examples: EY PeopleSoft, PwC Thomson Reuters, Deloitte Autonomy/HP

## PROFESSIONAL SKEPTICISM

*PCAOB Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in 12/4/12*

- 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.
- The PCAOB continues to observe instances in which circumstances suggest that auditors did not appropriately apply professional skepticism in their audits.
- Alert focuses on the importance of professional skepticism, the appropriate application of professional skepticism in audits, and certain important considerations for audit firms' quality control systems.

## PROFESSIONAL SKEPTICISM AND EXTERNAL AUDIT

- It seems auditors have never been skeptical enough
  - An examination of SEC Enforcement Actions 1987-1997 found 60% of enforcement actions related to a lack of professional skepticism. Beasley et al. (2001)
  - PCAOB's 2008 review of first four years of inspections of eight largest accounting firms found deficiencies attributable, at least in part, to lack of professional skepticism when performing audit procedures and performing audit tests.

## PCAOB 2008 REPORT

"In some instances, firms did not sufficiently test or challenge management's forecasts, views, or representations that constituted critical support for amounts recorded in the financial statements...Even in recent years, we are seeing deficiencies in the most important and high-risk areas of the audits, where appropriate levels of care and professional skepticism are needed," wrote George Diacont, director of the PCAOB registration and inspections division.

[CFO.Com Dec. 8, 2008](#)

## PCAOB INSPECTION PART TWO DISCLOSURES

Deloitte - Part Two Private Report for 2008 inspections of 2007 audits disclosed publicly October 2011.

“The nature and number of the reported deficiencies identified by the inspection team (including, in nine of the 61 engagements reviewed, the Firm's failure to obtain sufficient competent evidential matter, at the time it issued its audit report, to support its audit opinion) suggest that important issues may exist regarding...**The sufficiency of the Firm's emphasis on the critical need to exercise due care and professional skepticism when performing audits.**”

## PCAOB INSPECTION PART TWO DISCLOSURES

PwC Part Two Private Report for 2009, 2010 inspections of 2009, 2008 audits disclosed publicly 3/2013.

From 2009 report: “The nature and number of the reported deficiencies identified by the inspection team (including, in six of the 50 engagements reviewed, the Firm's failure to obtain sufficient competent evidential matter, at the time it issued its audit report, to support its audit opinion) suggest that important issues may exist regarding...***The sufficiency of the Firm's emphasis on the critical need to exercise due care and professional skepticism when performing audits.***”

# PROFESSIONAL SKEPTICISM AND EXTERNAL AUDIT

- The concept is pervasive in the standards
  - SAS 1 (AICPA, 1997)
  - SAS 82 (AICPA, 1997)
  - SAS 99 (AICPA, 2002)

## AU 316.13

- Due professional care requires the auditor to exercise professional skepticism. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud.
- Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.
- Professional skepticism requires an ongoing questioning ... the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

# PROFESSIONAL SKEPTICISM AND EXTERNAL AUDIT

Biases that are inherently created by the structure of the auditor-client relationship can be amplified by other aspects of human nature.

*UNCONSCIOUS HUMAN NATURE AFFECTING PROFESSIONAL SKEPTICISM, Kayla Gillan PCAOB Board Member, 1/23/07*

*Three academic references are cited repeatedly:*

*Mahzarin R. Banaji, Max H. Bazerman, Dolly Chugh, How (Un)ethical Are You?, Harv. Bus. Rev., December 2003*

*Max. R. Bazerman, George Loewenstein, Don A. Moore, Why Good Accountants Do Bad Audits, Harv. Bus. Rev., November 2002*

*Max R. Bazerman, Dolly Chugh, Decisions Without Blinders, Harv. Bus. Rev., January 2006*

## RECENT DATA

- The CAQ recently commissioned the authors of a 2010 report, *Fraudulent Financial Reporting: 1998–2007, An Analysis of U.S. Public Companies* to review the enforcement actions included in that study, provide a descriptive analysis of those investigations where the SEC sanctioned either the auditor or the audit firm and expand the study period through December 2010.
- From 1998–2010, the authors identified 87 instances of SEC investigations of fraudulent financial reporting leading to sanctions against auditors.

## RECENT DATA

- The SEC issued sanctions against individual auditors in 80/81 cases and sanctions against the audit firm in 27/81 instances. 26 cases involved sanctions against both.
- Most cases involved multiple alleged deficiencies.
- The top five areas cited by the SEC in these cases:
  - Failure to gather sufficient competent audit evidence (73 percent of the cases)
  - Failure to exercise due professional care (67 percent)
  - Insufficient level of professional skepticism (60 percent)
  - Failure to obtain adequate evidence related to management representations (54 percent)
  - Failure to express an appropriate audit opinion (47 percent)

## RECENT DATA

- The CAQ study covers 1998–2010, but only 11 of the cases occurred in 2003 or later, post- Sarbanes-Oxley Act 2002.
- Results track my results reported in [Forbes magazine in October](#). The SEC filed only 79 accounting fraud and disclosure cases in [2012](#), 11% less than in 2011 when there were 89, the fewest, by far, in a decade.
- Less general accounting fraud enforcement by SEC leads to fewer sanctions against the auditors. One follows the other. But even when SEC addresses general accounting fraud, enforcement against auditors and especially firms is rarer and rarer.

## UPDATES

- “We have only seen the SEC be active against accountants with the [Chinese reverse merger](#) cases,” said Cox, referring to cases involving China-based companies that bought public shell companies in the U.S. and reported false financial results.
- Inspections of auditors “repeatedly show an amazing lack of professional skepticism by accountants who repeatedly defer to very questionable applications” of the industry’s accepted accounting principles, he said.

*James Cox, a securities law professor at Duke University  
[in Bloomberg April 18, 2013.](#)*

# UPDATES

- Eight SEC cases in 2011 involving audit firms and auditors. Thirteen in 2012. Many cases involve multiple Accounting and Auditing Enforcement Releases (AAERs).
- 2011: Eight AAERs against firms and eleven against individuals.
  - Pumped up by Price Waterhouse India for Satyam; KPMG Australia for independence violations very similar to [KPMG activities at GE](#) that have not yet been sanctioned; enforcement order against Deloitte Touche Tohmatsu for its lack of cooperation in providing workpapers helpful to investigations of Chinese frauds.
- 2012: Large firm AAERs include one single order covering the Big Four and one more firm for lack of cooperation in the Chinese reverse merger fraud investigations and an independence violation by Deloitte South Africa involving a prohibited business relationship. The rest involve smaller firms and individual CPAs.

# UPDATES

- Former SEC Director of Enforcement Robert Khuzami claimed to me, in a November Forbes magazine article, that fewer restatements mean less accounting fraud and, therefore, even less need to prosecute audit firms and auditors?
- According to [research firm Audit Analytics](#), “revision restatements” were 64.69% of the restatements disclosed in 2012. This figure is the highest percentage since 2005 (the first full year the 8-K disclosure requirement was in effect).
- A “revision restatement”, according to Audit Analytics, is one included in a periodic report without a prior disclosure in Item 4.02 of an 8-K. Thus, it does not undermine reliance on past financials and is less disruptive on the market, meaning the stock price doesn’t suddenly and precipitously drop.
- I suggested to the SEC in Forbes in early June that restatements were a good place to start looking for accounting fraud.

## UPDATES

In early July the SEC announced the reestablishment of an Accounting Fraud Task Force.

“The Financial Reporting and Audit Task Force dedicated to detecting fraudulent or improper financial reporting, whose work will enhance the Division's ongoing enforcement efforts related to accounting and disclosure fraud.”

“The principal goal of the Task Force will be fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures. The Task Force will focus on identifying and exploring areas susceptible to fraudulent financial reporting, **including on-going review of financial statement restatements and revisions**, analysis of performance trends by industry, and use of technology-based tools such as the Accounting Quality Model.”

# UPDATES

## Audit Firm Rotation Proposals

On July 8, the U.S. House of Representatives voted 321-62 for H.R. 1564, the Audit Integrity and Job Protection Act.

I wrote in Forbes the next day:

“I’ve got news for the Congressmen and Congresswomen: The integrity of the audit industry is already shot to hell. Again. The only jobs you’re protecting belong to the audit industry, in business by virtue of the laws Congress enacted and the SEC enforces, albeit less strenuously lately, that require an audit be performed by a PCAOB registered public accounting firm for every public company and broker-dealer.”

## LUNCHEON ADDRESS

Auditor Independence, Skepticism, and Fraud: Case Studies and Examples

# AUDITOR INDEPENDENCE

## The Independence Standard

([SEC Final Rule 10/12/01](#))

“Independence generally is understood to refer to **a mental state of objectivity and lack of bias**. The amendments retain this understanding of independence and provide a standard for ascertaining whether the auditor has the requisite **state of mind**.

The first prong of the standard is **direct evidence of the auditor's mental state: independence "in fact."** The second prong recognizes that **generally mental states can be assessed only through observation of external facts**; it thus provides that an auditor is not independent if **a reasonable investor**, with **knowledge of all relevant facts** and circumstances, would conclude that the **auditor is not capable of exercising objective and impartial judgment.** “

## PROFESSIONAL SKEPTICISM AND EXTERNAL AUDIT

U.S. audit standards discuss auditors' responsibility to exercise increased professional skepticism in response to specific situations

- Confirmation procedures are one circumstance where an auditor has to exercise a heightened degree of professional skepticism. AU Section 330.37
- Examples: Satyam, Parmalat, Chinese reverse merger frauds

## RESPONDING TO SPECIFIC SITUATIONS

### Satyam Findings

- Control of the confirmation process ceded to client. Relied on Satyam's representations, in large part, because they believed that Satyam's former chairman and senior management were honest and that they did not suspect that Satyam was fabricating audit documents
- Failure to comply with the several PCAOB Standards
  - AU 230.07 [d]ue professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.
  - AU 230.09 [i]n exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.

## RESPONDING TO SPECIFIC SITUATIONS

- Some situational cues could indicate a higher level of risk or the need for additional fraud testing and the exercise of heightened professional skepticism.  
SAS 99
  - Koss, Lehman, Refco, Madoff feeder funds, Petters feeder funds
  - Higher fraud risk engagements should be audited with increased professional skepticism, IFAC
    - Anglo Irish, Madoff, Akai, Bally' s

# AUDITORS' OBLIGATIONS REGARDING FRAUD AND ILLEGAL ACTS

When fraud and illegal acts occur, what do auditors say?

# AUDITORS' OBLIGATIONS REGARDING FRAUD AND ILLEGAL ACTS

## General Requirements

- Paragraph .02 of AU sec. 110, Responsibilities and Functions of The Independent Auditor
- Sections 10A (a)-(f) of Securities and Exchange Act of 1934
- PCAOB's Auditing Standard 5
  - "When auditing internal controls over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities."
- AU sec. 230 Due Professional Care in the Performance of Work
- Auditing Standard 13 The Auditor's Responses to the Risk of Material Misstatement

## SECTION 10A

- Law requires auditors to report to the SEC when, during the course of a financial audit, an auditor detects:
  - Likely illegal acts that have a material impact on the financial statements, and
  - Appropriate remedial action is not being taken by management or the board of directors.

## SECTION 10A

- Section 10A added to the Securities Exchange Act of 1934 (15 U. S. C. 78j- 1) by the Private Securities Litigation Reform Act of 1995 (Public Law 104- 67).
- First became effective for fiscal years beginning on or after January 1, 1996.

## AUDITORS' OBLIGATIONS ACCORDING TO BIG FOUR LEADERSHIP

On the Satyam scam, early 2009 to the Times of India, PwC Global Chairman Sam DiPiazza:

*“What we understand is that this was a massive fraud conducted by the (then) management, and we are as much a victim as anyone. Our partners were clearly misled.”*

## AUDITORS' OBLIGATIONS ACCORDING TO BIG FOUR LEADERSHIP

Summer of 2010, PwC Global Chairman Dennis Nally in an interview in India re: Satyam:

*“Many times there is an expectation from the investor community that the auditor is in fact fully responsible for the detection of fraud. Now that is not our job, today.”*

## AUDITORS' OBLIGATIONS ACCORDING TO BIG FOUR LEADERSHIP

Dennis Nally, again, to the FT in June 2011:

*“There are professional standards out there [and] an audit is not designed under those standards to detect fraud,” he says, pointing out that detecting fraudulent behaviour rests on other indications including a company’s governance, management tone and control systems.*

*The reasons it has been done that way is because, while we always hear and read about the high-profile fraud, the number of those situations that you actually encounter in practice is very de minimis.*

*You’re not designing an audit for ‘the exception’ because, quite frankly, the cost itself would be prohibitive to all of the capital markets and ... who wants to pay or that if the benefit isn’t there?”*

***The Man Who Would Be Biggest, an interview with PwC Global Chairman Dennis Nally  
The Financial Times, June 26, 2011***

## AUDITORS' OBLIGATIONS ACCORDING TO BIG FOUR LEADERSHIP

Deloitte CEO Bill Parrett in April 2010 before retiring to join Blackstone Group, a Deloitte audit client:

*“...there are limits to what an auditor can detect – and those limits often fall far short of what investors expect from the process. “We’ve always had this expectation gap between what the auditor really can do and what the investing public wants the auditor to do, or wants the audit to represent,” he said.*

## CASE STUDY - SATYAM

On April 5, 2011, the SEC and the PCAOB announced settled disciplinary orders against five firms, members of the PwC global network, for violations of PCAOB rules and standards and for violations of federal securities laws as well as improper professional conduct by PW India while PW Bangalore served as auditor for Satyam.

## CASE STUDY - SATYAM

- SEC also sanctioned the PW India firms for, “violation of Section 10A(a) of the Exchange Act by failing to conduct procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.”
- No enforcement action for, “failing to report likely illegal acts that have a material impact on a company’s financial statements,” but instead for failing to perform the so that those illegal acts have a high likelihood to be detected.

## CASE STUDY ILLEGAL ACTS – FCPA, LIBOR, AML, TAX EVASION

- Wal-Mart and News Corp, FCPA Pending – EY
- Standard Chartered, AML – KPMG
- HSBC, Libor, AML – KPMG
- Las Vegas Sands, FCPA and AML - PwC
- American Express, AML - EY
- Deutsche Bank, Tax evasion 2X, now fair value accounting violations - KPMG
- UBS, Tax evasion, Libor, rogue trader – EY
- Barclays, Libor - PwC
- JPM, Bank of America, Libor - PwC
- Eli Lilly (2012), FCPA - EY
- Pfizer (2012), Siemens (2008 and largest ever fine), Daimler (2010), KBR(2009) FCPA – All KPMG

## CASE STUDY – CHINESE FRAUDS

- How many of the auditors of Chinese reverse merger firms who resigned because of suspicions of fraud filed 10A reports?
- Did auditors who mentioned, “circumstances that could constitute illegal acts for purposes of Section 10A of the Securities Exchange Act of 1934,” in their resignations file 10A reports?
- Did the auditors of the two PRC-based companies where the SEC issued stop order proceedings perform their duties under Section 10A?
  - For example, CCME, China Cast and Longtop audited by Deloitte, Sino Forest audited by Ernst & Young.

## CASE STUDY – CHINESE FRAUDS

- On October 3, 2011, the PCAOB issued Staff Audit Practice Alert No. 8, Audit Risks In Certain Emerging Markets.
- In just two months in 2011, according to the PCAOB, more than 24 companies with their principal place of business in the People's Republic of China ("PRC") filed Forms 8-K with the SEC reporting auditor resignations, accounting irregularities, or both.

## PCAOB IAG

### “AUDITORS IN FINANCIAL CRISIS”

- Dozens of the world’s leading financial institutions failed, were sold in fire sales, or were prevented from failing only through a massive government intervention – all without a hint of advance warning from auditors that anything might be amiss.
- Investors suffered devastating losses. Millions of Americans lost their homes or their jobs, and \$11 trillion in household wealth has vanished, according to the Financial Crisis Inquiry Commission.
- Serious questions raised both about the quality of these financial institutions’ financial reporting practices and about the quality of audits that permitted those reporting practices to go unchecked.

## CASE STUDY - FINANCIAL CRISIS

- Deloitte settles claims for failures of Bear Stearns, Washington Mutual.
- KPMG settles claims against for New Century and Countrywide early.
- Deloitte facing trial for Taylor Bean & Whitaker this June.
- Ernst & Young facing trial in class action suit and by NYAG for Lehman.
- PwC first audit firm sued by FDIC for crisis-era failure - Colonial Bank.

## WHY ARE AUDITORS RARELY WHISTLEBLOWERS?

- Judgmental, rigid, black and white morality that squashes skepticism. Mind made up.
- Followers not leaders
- Reluctance to be an “outlier” or ostracized for unpopular or uncomfortable views. “Pleasers”
- Lack of diversity breeds in-group bias.
- Lack of focus in undergraduate curriculum on independent, critical thinking skills.
- 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.)
- Recruiting focuses on “fit”, trainability, willingness to conform for future rewards, and respect for authority and precedent.
- Discomfort with change and uncertainty that arises from questioning values and tenets of profession, firm, colleagues.
- Career and financial security is a priority.

## Francine McKenna

**re: The Auditors**  
Founder and Editor

<http://retheauditors.com>

**Accounting Watchdog** at Forbes.com  
Columnist and magazine contributor

<http://blogs.forbes.com/francinemckenna>

**Accountable** at American Banker  
Columnist

<http://www.americanbanker.com/authors/1236.html>

[@retheauditors](#) on Twitter

LinkedIn: <http://www.linkedin.com/in/francinemckenna>

[fmckenna@mckennapartners.com](mailto:fmckenna@mckennapartners.com)

(312) 523-4188

McKenna Partners LLC provides specialized consulting to attorneys in cases involving the audit firms, in particular when they have a global reach. McKenna's knowledge of the internal operations of the firms especially on independence, legal and regulatory compliance, risk and quality management, internal systems/processes and global network legal and regulatory issues is unprecedented and rarely available outside the firms in an independent and objective form.

# AUDITORS' OBLIGATIONS REGARDING FRAUD AND ILLEGAL ACTS

APPENDIX TO  
“CONSIDERATION OF OUTREACH AND  
RESEARCH REGARDING THE AUDITOR’S  
APPROACH TO DETECTING FRAUD”  
SPECIFICS

# AUDITORS' OBLIGATIONS REGARDING FRAUD AND ILLEGAL ACTS

## General Requirements

- Paragraph .02 of AU sec. 110, Responsibilities and Functions of The Independent Auditor
- Sections 10A (a)-(f) of Securities and Exchange Act of 1934
- PCAOB's Auditing Standard 5
  - "When auditing internal controls over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities."
- AU sec. 230 Due Professional Care in the Performance of Work
- Auditing Standard 13 The Auditor's Responses to the Risk of Material Misstatement

## SECTION 10A

- Law requires auditors to report to the SEC when, during the course of a financial audit, an auditor detects:
  - Likely illegal acts that have a material impact on the financial statements, and
  - Appropriate remedial action is not being taken by management or the board of directors.

## SECTION 10A

- Section 10A added to the Securities Exchange Act of 1934 (15 U. S. C. 78j- 1) by the Private Securities Litigation Reform Act of 1995 (Public Law 104- 67).
- First became effective for fiscal years beginning on or after January 1, 1996.

## SECTION 10A

Fraud charges require materiality and scienter

- Materiality: Anything investors would consider important or change total mix of information available for making investment decisions.
- Scienter: Fraudulent intent including intentional or reckless conduct.
  - Intentional errors: Clear signs of fraud such as booking fictitious revenue, fabricating or altering books/records, misrepresenting facts.
  - Recklessness includes motive to cook the books combined with red flags that create inferences of fraudulent intent.

## SECTION 10A

- Recklessness
  - Unsubstantiated *top-side adjustments* that appear to help meet earnings expectations
  - Releases from reserves (cookie jar accounting) of amounts that enable executives to meet earnings expectations or incentive compensation thresholds

## SECTION 10A

More recklessness...

- Accounting and disclosure follow form of a transaction and not the substance
  - Abusive SPEs
  - "Round-trip" transactions
  - Debt masking type activities
- Red Flags
  - When companies make changes to their accounting policies
  - Change their methods of applying certain accounting principles
  - Reclassify balance sheet or income statement items

## SECTION 10A

SEC Enforcement: “Whenever we investigate alleged accounting fraud, not only will we assess audit deficiencies, but we will be assessing Section 10A compliance.”

***Remarks At The 2011 AICPA Conference By Howard Scheck,  
Chief Accountant, Division of Enforcement, SEC, December 6, 2011***

## SECTION 10A

SEC Enforcement will look at:

- What the auditor learned or knew
- What the auditor did after discovering a potential accounting error (or other illegal act)
- How the auditor monitored the company's response to potential illegal acts including
  - Whether the auditor has brought necessary subject matter, forensic, legal and risk expertise to bear on the particular issues.

***Accounting firm personnel could seek to recover whistleblower awards by alleging that their firm failed to comply with Section 10A.***

***Remarks At The 2011 AICPA Conference By Howard Scheck,  
Chief Accountant, Division of Enforcement, SEC, December 6, 2011***

## 10A STATISTICS

Fiscal 2011 metrics resulted in the SEC instituting 102(e) proceedings against 20 external auditors and 35 internal public company accountants.

***Remarks At The 2011 AICPA Conference By Howard Scheck,  
Chief Accountant, Division of Enforcement, SEC, December 6, 2011***

## 10A STATISTICS

- I sent a Freedom of Information Act Request to the SEC in 10/11.
  - *Are Auditors Reporting Fraud And Illegal Acts? The SEC Knows But Isn't Telling, [re: The Auditors, February 22, 2012](#)*
- I asked how many SEC actions were filed, by year, between 1/1/07 and 9/30/11 against auditors for alleged violations of Section 10A for failing to report likely illegal acts materially impacting on a company's financial statements.
- SEC replied in 12/11 that, “ a search was conducted of the Commission's various systems of records, **but did not locate or identify any information responsive to your request.**”

# AUDITORS' OBLIGATIONS REGARDING FRAUD AND ILLEGAL ACTS

## Consideration of Financial Statement Fraud in Planning an Performing Audit Procedures

- Paragraph .14 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatements*.
- Paragraph 7 of Auditing Standard No. 9, *Audit Planning*, and Auditing Standard No. 8, *Audit Risk*.
- Paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.
- Paragraph 15 of Auditing Standard No. 13
- AU sec. 330, *The Confirmation Process*.
- AU sec. 331, *Inventories*.
- AU sec. 334, *Related Parties*. The Board has proposed an auditing standard that would replace AU sec. 334. See PCAOB Release 2012-001.
- Auditing Standard No. 14.

# AUDITORS' OBLIGATIONS REGARDING FRAUD AND ILLEGAL ACTS

## Additional Fraud Considerations in Audits of Internal Control Over Financial Reporting

- Paragraph 14 and 15 of Auditing Standard No. 5.
- Auditing Standard No. 12.