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## SEC Investigation Of Accounting Firms Is A Good First Step

By **Jesse Jensen and John Rizio-Hamilton** (April 6, 2022, 5:15 PM EDT)

The U.S. Securities and Exchange Commission is reportedly conducting a sweeping investigation of conflicts of interest at accounting firms, including the so-called Big Four — EY, Deloitte, KPMG LLP and PwC.[1]

The probe purportedly concerns whether these and other accounting firms' practices providing consulting and other nonaudit services undermines their ability to conduct independent reviews of public companies' financials. As the SEC looks to Congress to increase its funding and staffing for the coming year,[2] it is crucial that the SEC commit to investigating these issues thoroughly to restore trust in our capital markets and prevent investor losses.

Under U.S. securities laws, auditors are the first line of defense for investors against improper and fraudulent accounting. As the U.S. Supreme Court recognized in 1984 in *U.S. v. Arthur Young & Co.*, federal regulations requiring public companies to have annual financial statements audited by independent auditors serves to "obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries." [3]

For that reason, the Supreme Court continued,

[i]t is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. ... If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.[4]

Thus, SEC regulations prohibit accounting firms from doing nonaudit work for an audit client that could impair the accounting firm's objectivity and impartiality.

History has repeatedly shown that these concerns about independence — that an auditor's objectivity and impartiality may be impaired by nonaudit work — are not just abstract. Among the more notorious examples is the criminal accounting fraud perpetrated at Enron Corp.

Enron's auditor, Arthur Andersen LLP, gave its seal of approval to Enron's fraudulent financials while also making millions of dollars from consulting work for Enron — with consulting fees even exceeding audit fees in the year preceding Enron's collapse.[5] As Andersen's failures and ethical lapses concerning Enron emerged, the accounting firm collapsed — turning what had been the Big Five into the Big Four.

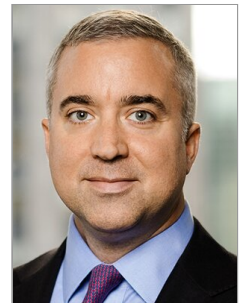
In the years since, even as Enron and other scandals heightened focus on the importance of auditor independence, the significance of consulting and other nonaudit business for the Big Four and other accounting firms continued to grow.[6]

During this time, these firms have paid millions to the SEC for alleged independence violations.[7] As SEC Enforcement Director Gurbir Grewal recently acknowledged, these penalties "are not having the desired deterrent effect" on independence violations, but instead alarmingly are "sometimes viewed as a cost of doing business." [8]

As Oxford professor Karthik Ramanna wrote in 2019, the crisis of trust faced by auditing is "an especially perverse situation given the audit's central role in fostering trust in markets." [9] A string of high-profile audit failures and alarming auditor misconduct in the short time since Ramanna published his conclusions has only



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worsened this crisis of trust.

For example, during the recent criminal trial of former Theranos CEO Elizabeth Holmes — in which Holmes was found guilty of multiple charges related to defrauding investors — the public learned that at least three Big Four accounting firms had been engaged to provide services to Theranos, including audits.[10] These accounting firms made millions of dollars in fees and never raised their hands to signal that something may be amiss.

As another example, further revelations have emerged about the audit failures surrounding Hewlett-Packard Enterprise Co.'s disastrous acquisition of Autonomy Corp., whose CEO faces criminal charges in the U.S. for alleged accounting fraud.

In September 2020, the U.K. Financial Reporting Council imposed a record fine on Deloitte UK for its role in failing to detect Autonomy's fraudulent accounting. As has been observed, Deloitte UK's deficient audits occurred at the same time as Deloitte's member firms across the world — including in the U.S. — provided consulting services to Autonomy, implicating the same sorts of independence concerns now under investigation by the SEC.[11]

Still other alarming revelations of misconduct have further rattled the bond of trust between investors and auditors, such as the criminal enterprise carried out to steal confidential information concerning KPMG's regulatory inspections. That scheme led to prison sentences for KPMG personnel, and KPMG agreed to pay a \$50 million penalty and retain an independent consultant to assess the firm's ethics and integrity to settle charges of its own admitted wrongdoing.[12]

Against this backdrop, the SEC's investigation comes at a critical time. Our capital markets are the economic lifeblood of our nation, and trust in the independent auditor is part of the backbone of that system. It is crucial that the SEC restore some of this lost confidence and finally address the systemic issues that have repeatedly harmed shareholders of public companies.

Critically, an investigation into auditor independence must be just the first step — not the last. There are indications suggesting that the SEC intends to build such momentum. The SEC's requested fiscal year 2023 budget looks to add 400 new staff positions and seeks an increase of more than \$53 million for the agency's Enforcement Division alone.[13]

With the benefit of additional resources, the SEC needs to follow its investigation with increased enforcement activity, including large fines that remove or at least curtail the economic incentive for the market's independent gatekeepers to turn a blind eye. Investors and our capital markets deserve nothing less.

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[1] D. Michaels, "Big Four Accounting Firms Come Under Regulator's Scrutiny," Wall St. J. (Mar. 15, 2022), available at <https://www.wsj.com/articles/big-four-accounting-firms-come-under-regulators-scrutiny-11647364574?mod=djemalertNEWS&fbclid=IwAR1dSQaVhFCwNe4mGMrhUkezhX5qEFTF4NyAvWIr-AqC5Q9FUSLLadJb8bQ>.

[2] See L. Berg, "SEC Seeks \$2.1B, 400 New Staffers In 2023 Budget" (Mar. 28, 2022), available at [https://www.law360.com/securities/articles/1478410/sec-seeks-2-1b-400-new-staffers-in-2023-budget?nl\\_pk=0d621f2e-36a4-4eac-99e4-1067c1544bf7&utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=securities&utm\\_content=2022-03-29](https://www.law360.com/securities/articles/1478410/sec-seeks-2-1b-400-new-staffers-in-2023-budget?nl_pk=0d621f2e-36a4-4eac-99e4-1067c1544bf7&utm_source=newsletter&utm_medium=email&utm_campaign=securities&utm_content=2022-03-29).

[3] *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984).

[4] *Id.*

[5] R. Abelson & J. Glater, "Enron's Collapse: The Auditors; Who's Keeping the Accountants Accountable?" N.Y. Times (Jan. 15, 2002), available at <https://www.nytimes.com/2002/01/15/business/enron-s-collapse-the-auditors-who-s-keeping-the-accountants-accountable.html>.

[6] See, e.g., M. Maurer, "Big Four Firms EY, Deloitte Report Higher Revenue," Wall St. J. (Sept. 9, 2021), available at <https://www.wsj.com/articles/big-four-firms-ey-deloitte-report-higher-revenue-11631222772>.

[7] See, e.g., D. Michaels, "Big Four Accounting Firms Come Under Regulator's Scrutiny," Wall St. J. (Mar. 15, 2022), available at <https://www.wsj.com/articles/big-four-accounting-firms-come-under-regulators-scrutiny-11647364574?mod=djemalertNEWS&fbclid=IwAR1dSQaVhFCwNe4mGMrhUkezhX5qEFTF4NyAvWIr-AqC5Q9FUSLLadJb8bQ> (noting payments for independence violations by PwC (\$8 million), E&Y (\$4 million), KPMG (\$8.2 million) and Deloitte (\$1.1 million)).

[8] See F. McKenna, "Here's a target list if SEC Enforcement really wants to "hammer" the gatekeepers" (Dec. 27, 2021), available at <https://thedig.substack.com/p/heres-a-target-list-for-if-sec-enforcement?s=w> (quoting remarks by Gurbir Grewal at December 8, 2021 AICPA SEC/PCAOB Conference).

[9] Karthik Ramanna, "Building a culture of challenge in audit firms" (Sept. 2019), p.3, available at <https://www.pwc.co.uk/who-we-are/future-of-audit/building-a-culture-of-challenge-in-audit-firms.pdf>.

[10] See F. McKenna, "Elizabeth Holmes and her Big 4 audit firm buddies at Theranos" (Jan. 6, 2022), available at <https://thedig.substack.com/p/elizabeth-holmes-and-her-big-4-audit?s=r>.

[11] See F. McKenna, "Deloitte, HP And Autonomy: You Lose Some But You Win Some More, Much More" (Dec. 1, 2012), available at <https://retheauditors.com/2012/12/01/deloitte-hp-and-autonomy-you-lose-some-but-you-win-some-more-much-more/>.

[12] See SEC Press Release, "KPMG Paying \$50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training Exams" (June 17, 2019); J. Godoy, "Ex-KPMG Partner Gets Year In Prison For Regulatory Fraud," Law360 (Sept. 11, 2019), available at <https://www.law360.com/articles/1197762/ex-kpmg-partner-gets-year-in-prison-for-regulatory-fraud>.

[13] See supra n.2; L. Beyoud, "SEC Would See Enforcement Funding Boost in Biden's Budget Plan," Bloomberg Law (Mar. 28, 2022), available at <https://news.bloomberglaw.com/securities-law/sec-would-see-enforcement-funding-boost-in-bidens-budget-plan>.

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