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SEC Muddles Message With Watered-Down E&Y Fine

By **Carmen Germaine**

Law360, New York (October 19, 2016, 10:38 PM EDT) -- The U.S. Securities and Exchange Commission aimed to send a strong message Tuesday by fining Ernst & Young LLP in the agency's first case against a Big Four firm for audit failures in seven years, but experts questioned whether the penalties were large enough to make other firms take notice.

In **Tuesday's enforcement action**, Ernst & Young agreed to pay $10.8 million in disgorgement and interest and a $1 million fine to settle the SEC's allegations that the firm failed to detect a massive accounting fraud at oil services giant Weatherford International PLC for four years despite numerous red flags. Weatherford paid its own $140 million fine on Sept. 27 to end claims it inflated its earnings by more than $900 million over several years by using deceptive income tax accounting.

SEC Enforcement Division Director Andrew J. Ceresney touted the settlement Tuesday in a press call as the first time the agency has fined a Big Four accounting firm for audit failures since 2009.

"Audit firms serve an essential role in protecting shareholders from falsified financial statements," Ceresney said. "Critical to discharging these obligations is the need for auditors to maintain their professional skepticism at all times."

Ceresney noted that the case is the third the agency's brought against a major audit firm in just over a year — the SEC also charged Grant Thornton LLP with ignoring auditing red flags last December and settled similar charges against BDO USA in September 2015 — and hinted it won't be the last.

"This is an area, auditing and audit firms and auditors, that's an important focus for us, and one that will continue to be," he said.

Jim Keneally, a partner at Harris St. Laurent & Chaudhry LLP, said the SEC is no doubt sending a message to audit firms in an effort to deter similar failings and make sure audit partners "keep their backbones" when dealing with clients. He added that the timing of the case may be intended to send a message as well, coming when many audit firms are working on corporate filings.

"The timing of sewing this up isn't lost on the intended audience," Keneally said.

David Chase, a partner with the Law Firm of David R. Chase PA and a former SEC prosecutor, agreed that any case naming a Big Four accounting firm is significant. But he said it's unlikely we'll see KPMG or Deloitte in the SEC's headlines anytime soon.

While the major auditors certainly do make significant auditing errors, Chase said, their size gives them the resources to catch frauds more readily than smaller firms might, though as large institutions with complex engagements, they tend to be careful and follow procedures.

"The cases that I typically see, it tends to be the smaller, under-resourced firms that don't have the experiences or don't have the resources and don't catch the fraud," Chase said.

Ernst & Young's alleged failings, by contrast, were the kind of "pretty serious allegations" that are less likely to appear at the major firms, according to Chase.

The SEC said that although Ernst & Young had designated Weatherford for "close monitoring" status, its highest-risk category, because of the risks posed by the company and its reputation for aggressive tax stances, the firm still failed to recognize numerous red flags.

As a result, the SEC said, the accounting firm didn't catch that Weatherford's Vice President of Tax James Hudgins and tax manager Darryl Kitay had made several unsubstantiated "plug" adjustments of hundreds of millions of dollars to lower the company's effective tax rate, or the average tax rate it paid on pretax profits.

An Ernst & Young tax senior working under tax partner Sarah Adams did question the adjustments, according to the agency, telling Adams in an email about one $439.7 million adjustment, "This deserves a huh?" But Adams and Ernst & Young partner Craig R. Fronckiewicz both accepted Hudgins' and Kitay's explanations for the adjustments and didn't perform reconciliations that likely would have caught the fraud.

Keneally said the case, although fact-specific, shows the SEC is warning auditors that they need to press clients on questionable accounting.

"You can't accept anything the client gives you and then walk away from it," Keneally said. "Once you raise an issue, you better carry out your inquiry fully."

But Chase also questioned whether the size of the fine would be enough to make serious waves in the accounting world. He called the $1 million fine "shockingly low," saying he was surprised the agency wouldn't reach for more to send a sterner message.

In comparison, in December 2015, Grant Thornton **paid a $3 million penalty** and disgorged $1.5 million for ignoring red flags and fraud risks in audits of two companies that were later charged with improper accounting, and in September 2015, BDO **paid a $1.5 million fine** and disgorged $600,000 for dismissing red flags and issuing false opinions about a staffing services company. Both firms also agreed to admission of wrongdoing, which is considered a significant additional penalty that the SEC says it seeks in cases of egregious wrongdoing, while Ernst & Young settled without admitting or denying wrongdoing.

In fact, Tuesday's penalty isn't even the largest fine Ernst & Young has paid to the SEC in the past 30 days. On Sept. 19, the firm paid **a total penalty of $2.2 million**, plus $7.1 million in disgorgement, in two cases over audit partners who allegedly got too close to their clients.

Compared with similar cases and considering the alleged conduct, Chase said the fine is "incredibly small" and effectively lowers the cost of violating securities laws.

"Just my ballpark sense, I'm surprised it's not multiples of that 1 million," Chase said.

Ceresney said at the press conference that the SEC had determined the additional penalty of an admission of wrongdoing "wasn't necessary to resolve the case" but added that the agency feels the case sends a "strong message" with its "significant financial penalty" and other undertakings Ernst & Young agreed to. The firm agreed to review its quality controls and submit a series of reports to the SEC.

The enforcement chief also suggested the penalty was reduced because of Ernst & Young's previous remediation and the firm's "significant cooperation" with the SEC.

One part of the penalty package that might make other auditors straighten up even if the financial fines aren't attention-grabbing enough is the penalties the SEC set against Fronckiewicz and Adams, the Ernst & Young partners on the Weatherford audit, Keneally said.

Both were suspended from appearing before the commission as accountants, with Fronckiewicz allowed to apply for reinstatement after two years and Adams after one year. Adams is the first case the SEC has brought against a tax partner who was part of an audit team.

“If you’re a partner or a manager at a major auditing firm, that’s probably one of the things that stands out because that’s your personal livelihood that’s being adversely and potentially permanently affected,” Keneally said.

Ernst & Young issued a statement Tuesday saying audit quality is “central” to the firm and all of its stakeholders.

“Since the time of the Weatherford audits, and as referenced in the SEC order, EY has taken significant steps in improving audit quality,” the statement said. “Our commitment to audit quality is ongoing, and we are continually reviewing and enhancing our audit procedures, policies and training of our people.”

Representatives for Fronckiewicz and Adams did not respond Wednesday to requests for comment.

Ernst & Young is represented by William McLucas of WilmerHale. Fronckiewicz is represented by William Maguire of Hughes Hubbard & Reed LLP.

Adams is represented by Michael Warden of Sidley Austin LLP.

The SEC is represented by Jim Valentino, Ilana Sultan, Natalie Lentz, Kevin Lombardi, Kara Brockmeyer and Tracy L. Price.

The case is In the Matter of Ernst & Young LLP et al., case number 3-17628, before the Securities and Exchange Commission.

--Editing by Christine Chun and Brian Baresch.
