

Audit Watchdog, KPMG Face Big Hit To Credibility

By **Dunstan Prial**

Law360, New York (January 23, 2018, 10:47 PM EST) -- The Public Company Accounting Oversight Board and KPMG have suffered significant blows to their credibility stemming from criminal charges levied Monday that former employees of the audit watchdog gave stolen confidential information to high-placed accountants at the Big Four firm, experts said Tuesday.

The PCAOB's mission of overseeing the accounting firms that audit publicly traded companies lies at the heart of market integrity because investors rely on the information included in companies' financial statements to make informed decisions, experts said.

Investors are equally reliant on the credibility of the regulatory agencies and auditing firms such as KPMG that put their stamp of approval on the financial statements provided by public companies to investors, they said.

"It's a huge credibility hit," said David Chase, a former U.S. Securities and Exchange Commission prosecutor and now principal in his own Florida-based defense firm. "The fact that there were people inside the PCAOB that were trading essentially inside information — proprietary information — for personal benefit, which essentially allowed KPMG to circumvent the whole regulatory structure, is a huge black eye for that organization and to a large extent KPMG as well."

If the allegations prove isolated rather than systemic, however, the damage to PCAOB and KPMG's credibility could be limited.

"It really does depend on whether this is the tip of the iceberg or whether it's an isolated incident," said Ira Matetsky, a partner at Ganfer & Shore LLP. "If this is one person or one group of people who misbehaved and they are treated in a way that deters other people from doing it in the future, it may have limited long-term effect."

Federal prosecutors in New York on Monday charged three former members of the PCAOB and three former top KPMG executives with using stolen confidential information to help KPMG obtain better results on audits conducted by the board. All six were also named in civil administrative proceedings by the SEC.

The criminal indictments say former PCAOB employees Brian Sweet, Cynthia Holder and Jeff Wada passed along PCAOB information related to future inspections of KPMG to the three KPMG executives. Sweet and Holder had been hired at KPMG and Wada was seeking a job there when the scheme unraveled, prosecutors said. The former KPMG employees charged, David Middendorf, Thomas Whittle and David Britt, encouraged and participated in the scheme, prosecutors said.

Experts told Law360 that while the government's claims probably weren't unprecedented, none could recall seeing a group of securities regulators criminally charged with illegally helping a company they regulated in exchange for a career boost.

"It's a shock because it really undercuts the whole regulatory scheme," Chase said. "Evidently there was just a complete breakdown and lack of integrity in that process. It just really hits at the heart of the regulatory scheme."

Mitchell Littman, a partner at Littman Krooks LLP, described the government's allegations as

"astonishing" and said the charges should prompt KPMG's competitors to check for gaps in their own internal policies and procedures.

Other U.S. accounting firms are likely asking whether "this is just one basket with some rotten fruit, or do all the baskets have to be reviewed?" Littman said. Those firms should also be taking steps to review their own internal policies and procedures, he said.

"I can assure you that in the boardrooms of those other firms they're all looking at each other and saying, 'Thank God it wasn't us, and what are we doing to make sure it won't be us?'" he said.

What's more, Littman said public companies whose audits were done by KPMG should determine whether any of the people charged Monday participated in those audits.

"That's a critical step that any audit committee of any of the public companies should have to take," he said. "It doesn't mean that they necessarily did any bad things with your numbers, but it's a credibility issue out of the box, and I think it's something that you need to investigate."

A KPMG spokesman did not respond to a request for comment Tuesday. The accounting firm said in a statement Monday it is cooperating with the government's investigation and has taken action to strengthen its policies to prevent another similar breach. KPMG has said it "promptly" alerted authorities when the leak was discovered in early 2017.

Chase said the scandal at the PCAOB can be traced to the revolving door of government employees who jump ship for better paying jobs in the private sector, often at the companies they previously regulated.

"What we're seeing here is the dangers of having this kind of revolving door where you have those who are the regulators go to work for the regulated," he said.

The PCAOB should improve its vetting process to ensure it isn't hiring anyone with any "prior issues or red flags," Chase said.

Colleen Brennan, a PCAOB spokeswoman, told Law360 on Tuesday the allegations prompted the board to strengthen its "defenses" in several areas, including information technology and security. "Through systems and related policies, we tightened internal access restrictions to inspection plans," Brennan said. "We applied new IT monitoring to enhance our ability to prevent and detect potential misuse of our information."

In addition, the PCAOB updated its ethics code to bar senior inspections staff from seeking employment with firms they inspect for one year. The PCAOB also re-examined human resource practices and policies by enhancing employee education "to reinforce our mission and values," she said.

Littman said there's only so much regulatory bodies can do to prevent misconduct by their employees.

"I would like to strongly believe that this is an isolated incident," he said. "These things are going to happen when, unfortunately, greed surpasses peoples' personal integrity and professionalism. There's no rule or regulation that's ultimately going to govern those types of people."

The government is represented against Sweet and the other five defendants by Assistant U.S. Attorneys Rebecca Mermelstein, Amanda Kramer and Jessica Greenwood.

The SEC is represented in the administrative proceedings by Ian Rupell, Rami Sibay, Melissa Armstrong and Fred Block.

Sweet is represented by Richard Morvillo of Orrick Herrington & Sutcliffe LLP. Middendorf is represented by Greg Bruch of Bruch Hanna LLP. Whittle is represented by James Bicks of Wiggin and Dana LLP. Britt is represented by Rob Stern of Orrick Herrington & Sutcliffe LLP. Holder is represented by Norman Bloch of Thompson Hine LLP. Wada is represented by Stephen R. Cook of Brown Rudnick LLP.

The criminal cases are U.S. v. Brian Sweet, case number not available, and U.S. v. David Middendorf et al., case number 1:18-cr-00036, in the U.S. District Court for the Southern District of New York.

The administrative proceeding against Sweet is proceeding number 3-18347, and the proceeding against the others is 3-18346, at the U.S. Securities and Exchange Commission.

--Editing by Brian Baresch and Breda Lund.

Update: This story was updated to include additional counsel information.