



Real Cases

A LITTLE BACKGROUND

- Investigations begin with complaints from clients or others, referrals from other agencies, or the work of Board staff.
- Respondent and complainant both provide information
- File is reviewed by the Professional Standards Committee
- Majority of cases result in no discipline
- Most disciplinary matters settled by consent
- CPA may always request a hearing by full Board

BY THE NUMBERS

TOTAL CASES LAST YEAR	218
3 RD Party Complaints	54
Consent Orders	34
Use of Title	55
Audit Quality	29
CPE	24

FOR EXAMPLE

- In November 2021 NC Board censured KPMG Raleigh partner
- In January 2022 NC Board censured another KPMG Raleigh partner

KPMG STRIVES FOR AUDIT QUALITY

BACKGROUND

- PCAOB inspects audit firms with 100+ SEC audit clients every year
- 2014 inspection report of KPMG found 54% of audits had failed to obtain sufficient evidence to support opinion
- Deficiency rate had steadily increased from 22% in 2010 to 54% in 2014
- KPMG understood that SEC had been “highly critical” of worsening inspection results

KPMG TAKES ACTION

- May 2015 hired Associate Director at PCAOB (Brian Sweet) who had worked on team inspecting KPMG
- Sweet joined the firm as a partner in the Audit Quality and Professional Practice group (“AQPP” or “National Office”) responsible for PCAOB inspections

ACTIONS BY SWEET

- Before leaving PCAOB, Sweet copied confidential inspection related materials he believed might be useful at KPMG
- Materials included list of clients to be inspected in 2015, focus area of each inspection, and list of quantitative and qualitative criteria used to decide selections
- Put information on hard drive of his computer at KPMG

HOW IT STARTED

- First day at KPMG, during lunch with David Middendorf, KPMG's National Managing Partner for AQPP, questions start about which clients will be inspected
- Next day Middendorf told Sweet:
 - “Share insight and add value and be fully open when it comes to this type of information”
 - “Remember where your paycheck comes from”
 - Had to be “Completely loyal to KPMG and KPMG only”

HOW IT DEVELOPED

- Sweet sent complete list of planned inspections to partner he reported to, Thomas Whittle, KPMG's National Partner-In-Charge for Quality Measurement, who in turn sent it to Middendorf.
- Accompanying message was "The complete list. Obviously very sensitive. We will not be broadcasting this."

GETTING READY

- Sweet is assigned to review workpapers of one of the inspection targets—files had been locked so no changes
- Sweet explains to partners of targeted audits why they were selected so that they can better tailor their responses to PCAOB inspectors
- KPMG believed effective first response had significant impact on whether PCAOB would find deficiencies

OTHER SWEET ACTIONS

- April 2015 KPMG hires outside consultant to predict audits to be picked in 2016
- Sweet is directed to share confidential PCAOB information with consultant and tried to guide their modeling
- Sweet provided confidential PCAOB information about a bank that was a KPMG target client

ADDING HOLDER

- Before he left PCAOB, Sweet talked with Cynthia Holder about joining him at KPMG
- Before Holder left PCAOB, she furnished Sweet with PCAOB documents to help KPMG prepare for meeting with PCAOB to discuss audit deficiencies
- KPMG hired Holder as an Executive Director in their National Office

THEN CAME WADA

- Jeffrey Wada became angry when not promoted at PCAOB
- March 2016 Wada gave list of KPMG clients to be inspected to Holder
- SEC had just expressed “significant concern” about KPMG audit quality and Sweet was instructed to use the list to protect the firm from further criticism
- Firm personnel could still access the workpapers

TOO GOOD TO BE TRUE

- Additional review of selected bank audits conducted under false pretenses
- National office partners and managing directors suggested edits and revisions to workpapers
- Unlike prior years, 2016 inspection had no comments about ALLL where KPMG had historically received criticism
- PCAOB designated 2 of the audits as “positive quality events”

HOLD THAT REPORT

- PCAOB did not publish the report because KPMG reported the misconduct before it was issued
- PCAOB conducted 10 additional inspections of banks for the 2016 cycle
- Of these, 6 had deficiencies with respect to auditing ALLL

HOW DID KPMG FIND OUT?

- January 2017 Wada provided Holder preliminary list of PCAOB inspection targets and in February provided a list of 47 audits
- Middendorf said “This is information that’s too good not to use”
- Engagement partners were warned about inspections
- One of those partners suspected KPMG was getting confidential information and reported to management

WHEN DID MANAGEMENT KNOW?

- Scott Marcello had been promoted to Vice Chair of Audit in July 2015, in part, to improve relationship with PCAOB
- Marcello learned from Middendorf about the advance information in March 2016 and in February 2017
- Marcello knew the information came from someone inside the PCAOB but did not report it until he learned of the negative reactions of others at KPMG

BUT WAIT, THERE'S MORE

- As part of a 2017 settlement for failure to properly audit financials of an oil & gas client, SEC had ordered KPMG audit professionals to complete 12 hours of specific CPE
- KPMG administers its own online training; if you don't pass you don't audit, and compensation may be reduced

HOW TO GET A PASSING GRADE

- Auditors who passed sent their answers to colleagues
- This took place at all levels, including lead audit engagement partners
- Several of whom solicited answers from and sent answers to subordinates
- Note that outside law firm found most of this activity was among junior personnel

HOW NOT TO HIDE

- Prior to investigation, no one reported sharing answers
- After investigation began, certain “now-former” professionals attempted to conceal their actions
- After receiving document preservation notice, former partner deleted text from his source and encouraged source to do the same and say it was an accident
- Another partner answered “NO” on questionnaire but had received answers 7 times and given them 3

ANOTHER WAY TO PASS

- Prior to 2015, KPMG hosted exams on an internal server
- Participants received hyperlink in which was embedded score necessary to pass the exam
- By changing number in hyperlink, participants could change passing score
- 28 people did that 4 or more times
- Certain professionals reduced passing to 25% or less

VIOLATIONS

- PCAOB Rule 3500T requires compliance with ethics standards, including AICPA Code of Professional Conduct
 - Maintain integrity
 - Not commit an act discreditable to the profession
- Also, violations of various SEC and PCAOB rules and standards

UNDERTAKINGS

- Review quality controls for ethics and integrity
- Report to the Commission
- Special Committee of independent directors and non-audit partners
- Independent Consultant to review policies & procedures
- Additional ethics and integrity training for 3 years
- KPMG was censured and paid \$50,000,000

FOR THE PEOPLE

- 6 individuals were named in the matter of inspections
- 4 cooperated with the investigation and the SEC has ruled they can no longer practice before the Commission as accountants
- Middendorf and Wada were convicted of wire fraud and conspiracy to commit wire fraud and sentenced to federal penitentiary
- Marcello was censured and paid \$100,000 civil penalty

ON TOP OF THAT

- Texas Board of Accountancy has penalized KPMG \$2,000,000
- In November 2021 KPMG censured and paid \$29,000 civil penalty to NC

WHY DID THIS HAPPEN?

HIDDEN BRAIN™

**“When
Doing Right
Feels
Wrong”**

- April 18, 2022

ANOTHER CASE AS A RESULT (MAYBE)

THIS TIME IT'S EY

- SEC conducted investigation of potential cheating
- Before and during the investigation a “significant number of EY audit professionals cheated on ethics... as well as on a variety of other examinations required to maintain their CPA licenses.”
- EY withheld this misconduct from the SEC staff

THERE'S A PATTERN HERE

- From 2017 to 2021, 49 EY audit professionals exchanged answer keys to ethics exams
- Hundreds of others cheated on CPE courses
- Significant number of professionals who did not cheat but knew others did violated the firm's Code of Conduct by failing to report this misconduct

A LITTLE BACKGROUND

- In December 2014, whistleblower reported a flaw in EY's software that allowed passing CPE exams without the required number of correct answers
- Firm determined that from 2012 to 2015, over 200 audit professionals in multiple offices exploited this flaw
- In 2016, professionals in Denver shared answer keys
- In 2017, EY learned two employees cheated on ethics exam

EY'S COMMUNICATION

- Internally:
June 19, 2019, from US Managing Partner-“ sharing answers...is highly unethical behavior, in violation of our Code of Conduct, and will not be tolerated at EY.”
- Externally:
June 20, 2019, letter to Enforcement described 5 matters, including the 2 ethics exam cheaters in 2017. Nothing about ongoing misconduct.

WHY IS THAT A PROBLEM?

- EY's June 20 submission implied there's not a current issue
- On June 19, an employee reported to a manager that a professional had sent answers to ethics exam
- That afternoon, manager reported this to HR
- By June 21, senior EY attorneys knew of this tip
- Began extensive investigation but did not correct submission to SEC

EY'S INVESTIGATION

- By the fall of 2019, EY knows of “significant misconduct”
- Audit professionals in multiple offices cheated on ethics exams and a wide variety of other CPE courses
- 91 audit professionals requested, used, or shared answer keys *after* managing partner message about KPMG and the importance of integrity and not cheating

WHAT PARTICIPANTS SAID

- Many said they knew they violated EY Code of Conduct, but they cheated “because of work commitments or an inability to pass training exams after multiple attempts”
- Professionals had an obligation to report unethical conduct but failed to do so due to “lack of appreciation that sharing exam answers constituted cheating...and a desire to avoid getting colleagues in trouble”

IT WASN'T JUST LOWER LEVELS THAT KNEW OF PROBLEMS

- October 2019 General Counsel discussed investigation with Executive Committee
- By then senior management and senior attorneys knew:
 - SEC had sanctioned KPMG
 - SEC had asked about tips
 - EY had received a tip
 - Cheating involved many people in more than one office
 - EY had not disclosed the tip

SEC IS NOT PLEASED

- EY did not correct its submission
- EY informed PCAOB—but not right away (it took 4 months)
- SEC did not learn about the matter until March 2020
- Although EY conducted a “robust investigation” they did not “self-police, self-report, remediate, or cooperate in the Commission’s investigation”

HOW SEC SEES IT

- EY's actions hindered the SEC's ability to take action to protect investors from auditors who:
 - Don't understand their ethical obligations
 - Fail to act with appropriate integrity
 - Have not met (or needed to cheat to meet) minimum requirements to demonstrate knowledge of GAAP

VIOLATIONS AND UNDERTAKINGS

\$100,000,000

**HOW COULD THIS
HAPPEN?
COULD IT HAPPEN TO
YOU?**

ERNST & YOUNG GOES FOR GROWTH

MY ORIGINAL FIRM

- EY in Charlotte has experienced significant growth since I was there
- Rapid growth impacts the culture of any organization
- People who contribute to growth receive recognition
- Focusing on growth may cause loss of sight on other important matters

WHAT HAPPENED?

- In July 2014, Sealed Air announced the relocation of its headquarters to Charlotte
- SEC says EY and the three partners (Herring, Young, and Fochtman) engaged in “improper professional conduct” from 2014 through 2015 in pursuit of the Sealed Air audit engagement
- SEC also says the “now former” CAO (Stiehl) at Sealed Air violated SEC rules by aiding EY in this pursuit

BACKGROUND

- From 2004 through 2012, Herring, before becoming a partner, served on two audits where Stiehl was the primary contact
- January 2013 Stiehl was hired by Sealed Air and beginning in February 2013 participated in discussions to begin RFP process for the audit
- August 2013 Stiehl provided EY, exclusively, draft RFP presentation to the Audit Committee

BACKGROUND

- May 2014 Stiehl provided EY with timing of RFP and during that call shared confidential news of pending relocation to Charlotte
- Stiehl allowed EY to assist in drafting portions of the RFP
- EY was granted access to financial personnel at least a month ahead of other firms
- Internal EY “victory case study” said this was “head start none of the other firms were given”

RFP PROCESS

- July 2014 EY and three other firms (including KPMG, the incumbent) invited to submit bids
- RFP says process intended to allow all firms “equal opportunity to provide their best proposals” to the audit committee
- Also says all non-public information submitted by the firms would be confidential and each firm signed a bi-lateral Non-Disclosure Agreement

RFP CONFLICTS OF INTEREST

- RFP contained a conflicts of interest paragraph that made it clear that all firms submitting proposals represented:
 - Sealed Air personnel have not participated in preparation of proposal
 - Sealed Air personnel have not conveyed to the firm any information pertaining to the RFP

HOW IT REALLY HAPPENED

- Stiehl provided EY, through Herring, the competing firms' proposals and submissions, the details of each bid, and all the internal documents prepared for the audit committee
- This information was shared with the EY engagement and pursuit teams and then with EY regional and national leadership

HOW IT REALLY HAPPENED

- Stiehl also gave EY an “open invitation” to provide “suggestions and comments” to RFP materials summarizing each competitors' proposals that were going to the audit committee
- Stiehl provided information outside of the RFP data room, including “integral” incumbent fee information, which enabled EY to “come up with an informed fee for the RFP”

HOW IT REALLY HAPPENED

- Stiehl furnished copies of all competing bids to Herring (note that incumbent's bid included an "irreparable harm" confidentiality provision)
- Stiehl asked for help from Herring to show that one of the firms had insufficient audit experience with clients this size
- EY internal emails stated that "this is for our benefit and will not be shared with other firms"

WHAT EY DID WITH INFORMATION

- Circulated broadly throughout EY, including to EY partners working on other RFP opportunities
- Competitors' full proposals shared with over 20 EY people, including regional and national leadership
- EY Business Development sent email to at least 180 EY professionals which said information was obtained "thanks to a trusted relationship by one of our partners"

WHAT CAO DID

- Stiehl shared presentation to audit committee with Herring before meeting to get additional “cons” about other firms
- After audit committee selected EY and incumbent as finalists, Stiehl shared with Herring email from incumbent asking about revising fee
- That same evening, Stiehl had dinner with Herring and then attended Panthers game in EY suite with Fochtman and others

WHAT CAO DID

- Stiehl informed Herring that incumbent was changing fee and said “Don’t send me anything yet”
- Incumbent sent revised proposal with 5% fee reduction which Stiehl forwarded to Herring and Fochtman within 7 minutes
- Stiehl agreed with EY on a final bid that was almost identical to incumbent’s
- Stiehl omitted EY expenses from bid information to audit committee so EY appeared lower

SELECTION

- On November 11, 2014, audit committee selected EY
- EY Charlotte partners sent email to EY National leadership saying this was “\$10 million a year annuity which will span across multiple service lines”
- Stiehl sent another EY partner (his college roommate) an email with the message “Back in the family!!!”

WHAT EY WON

- Largest audit client in the Charlotte office

YEAR	AUDIT	AUDIT RELATED	TAX	TOTAL
2015	7,821	478	4,919	13,218
2016	7,101	1,261	5,316	13,678
2017	6,442	3,479	5,194	15,115
2018	7,151	405	2,155	9,711
TOTAL	28,515	5,623	17,584	51,722

AUDIT COMMITTEE ACTION

- In June 2019, audit committee discovered RFP related conduct
- Unanimously terminated Stiehl's employment for cause
- In August 2019, unanimously terminated EY's engagement
- Named PwC as auditor with total fees of \$13,670,000

WHAT THE SEC SAID

- Actions by EY and the partners during the RFP process made them not independent and they engaged in improper professional conduct
- This caused Sealed Air to file 2015 financial statements that were not audited by an independent accountant
- EY's system of quality control did not provide adequate protection to prevent this from happening

IMPACT TO EY

- EY had to give its personnel copy of SEC order
- EY introduced new policies and incorporated them into training
- For two years, EY must report to SEC staff effectiveness of new policies including certification by assurance leader
- EY is censured
- EY ordered to pay \$10,000,000 civil penalty

IMPACT TO THE PARTNERS

- Denied privilege of appearing or practicing before SEC as accountants (Herring for 3 years, Young for 2, and Fochtman for 1)
- Ordered to pay civil penalties of \$50,000 (Herring), \$25,000 (Young), and \$15,000 (Fochtman)

IMPACT TO STIEHL

- Denied privilege of appearing or practicing before the SEC for 2 years
- Ordered to pay \$51,000 civil penalty
- NC imposed a 2-year revocation

NC BOARD PROCESS

- NC Board Professional Standards Committee considered case in October; finalized April 21, 2022
- EY “consented to entry of ... Consent Order”
- Firm was censured and paid \$125,000 civil penalty
- Herring paid \$10,000 and certificate was revoked 3 years (but that was stayed)
- Young revoked 2 years and Fochtman 1 year but both had already given up certificates

WHY DID THIS HAPPEN?

"This fascinating book holds up a desperately needed mirror that objectively reveals a reflection we might not want to see. Yet through experienced guidance and genuine input, Bazerman and Tenbrunsel offer solutions that can powerfully change the way we do business."

—**Stephen R. Covey**, author of *The 7 Habits of Highly Effective People* and *The Leader in Me*

Blind Spots

Why We Fail to Do
What's Right and
What to Do about It

Max H. Bazerman
Ann E. Tenbrunsel

The Oath Of A North Carolina CPA

CPA

I Will Support the Laws And Regulations of the State of North Carolina

CPA

I Will Perform My Professional Duties to the Best of My Ability and Abide by The Rules Of Professional Conduct; and

CPA

I Will Uphold the Honor and Dignity of the Accounting Profession by Serving with Integrity, Objectivity, and Competence.

Thank You