

Expect More SEC Enforcement Against Auditors This Year

By **Charles Smith, Anita Bandy and Andrew Fuchs** (January 12, 2023, 6:21 PM EST)

At the end of both **2020** and **2021**, we forecasted that the incoming Biden administration would prioritize enforcement actions against auditors as gatekeepers, leading to higher activity levels for such actions.

We also noted, however, that because changes in enforcement priorities take time to implement, and there is a lag from the time of those changes to the public seeing their results in disclosed settlements and resolutions, we did not expect to see evidence of increased enforcement actions until late 2021 or early 2022.

We have not yet seen an uptick in U.S. Securities and Exchange Commission enforcement actions against auditors. In 2022, the SEC continued its trend of bringing fewer enforcement actions against auditors than it had under the prior administration. The SEC brought 13 enforcement actions against auditors in 2022.

As a point of comparison, the SEC brought 44 such actions in 2015, but only 11 in 2020 and 12 in 2021. However, 2022 was significant in that we saw the SEC levy the largest monetary penalty ever against an audit firm and impose a new set of undertakings that could serve as a template for settlements with audit firms for violations of auditing standards in certain circumstances.

As to our outlook for 2023, we think recent statements by Paul Munter, acting chief accountant at the SEC, indicate a likelihood that the SEC will prioritize enforcement actions against auditors as gatekeepers, and thus we continue to expect to see a reversion to higher activity levels for such enforcement actions.

Background to Rule 102(e)

SEC Rule of Practice 102(e), which was codified in Section 602 of the Sarbanes-Oxley Act, allows the SEC to seek relief against an individual auditor or audit firm that has intentionally, willfully or negligently violated professional auditing or accounting standards.

For these violations, the SEC typically seeks relief such as censures, cease-and-desist orders, fines, remedial forward-looking relief such as suspensions from appearing or practicing before the SEC for a specific number of years, after which the auditor or firm may apply for reinstatement if the suspension imposed is not permanent.

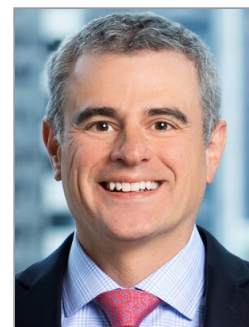
For an auditor, the implications of a suspension go beyond the ability to audit for the duration of the bar. Under the SEC's broad view, a bar generally prohibits any work relating to the preparation of financial statements of a public company or its affiliates. This can significantly limit the scope of nonaudit work an individual can undertake during a bar period and could pick up activity such as contributing to a draft SEC filing.



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In 2013, the SEC launched Operation Broken Gate to prioritize enforcement actions against auditors by holding accountable those auditors who violate professional auditing or accounting standards. This announcement marked the beginning of a period of increased use of Rule 102(e) to charge auditors that failed to adhere to professional standards.

Under Operation Broken Gate, the SEC charged or settled a wide range of Rule 102(e) cases, including against auditors from prominent national firms and the firms themselves.

2022 Activity Under Rule 102(e)

The number of Rule 102(e) charges and settlements against auditors for violations of professional auditing or accounting standards has declined in recent years as compared to the period following the announcement of Operation Broken Gate.

In 2022, the SEC charged or settled with eight individual auditors under Rule 102(e), as compared with 10 in 2021, nine in 2020, 13 in 2019, nine in 2018, 18 in 2017, 29 in 2016 and 28 in 2015. Similarly, the total number of enforcement actions against individual auditors and audit firms is 13 in 2022, as compared to 12 in 2021, 11 in 2020, 23 in 2019, 17 in 2018, 22 in 2017, 42 in 2016 and 44 in 2015.

The 2022 fact patterns for charges against auditors are consistent with actions over the past few years. This year's activity stemmed from six investigations. Three of those investigations resulted in settlements with three audit firms, Friedman LLP, RSM US LLP, CohnReznick LLP and seven of their individual auditors where the SEC alleged that these firms violated professional standards.

Another investigation resulted in a settlement with an individual auditor for violations of professional responsibilities. The fifth investigation resulted in a settlement with the Chinese affiliate of Deloitte where the SEC found that the firm failed to comply with U.S. auditing requirements. The sixth investigation resulted in a settlement with Ernst & Young LLP in connection with claims that the firm's employees cheated on ethics exams.

The settlements with individuals resulted in censures, cease-and-desist orders, and Rule 102(e) suspensions that ranged up to five years. The settlements with audit firms involved censures, cease-and-desist orders, undertakings and civil monetary penalties that ranged from \$1 million to \$100 million.

The \$100 million penalty relating to employees cheating on ethics exams is the largest monetary penalty the SEC has ever imposed on an audit firm. Although it involved a unique set of circumstances unrelated to auditing a client, the sheer size of this penalty may show that the SEC will require greater monetary amounts in the future to settle conduct that it views as breaches of trust by gatekeepers.

In addition, the settlement with CohnReznick is significant because it involved a unique set of undertakings. In a settlement for violations of professional standards, the SEC prohibited the audit firm from taking on a new audit client if:

- The new engagement would begin more than nine months after the prior fiscal year-end date for entities;
- The new audit client conducts the majority of its operations outside the U.S., unless such foreign operations are audited by a Public Company Accounting Oversight Board-registered firm;
- The new audit client has an unremediated material weakness in its internal controls over financial reporting; or

- The new audit client has received an audit report with a going concern opinion as of the end of the past fiscal year.

These restrictions remain in place until an independent compliance consultant confirms that that audit firm has brought itself into compliance with professional standards.

Although these undertakings appear to be the first of their kind, we expect to see more like them.

In particular, the undertaking prohibiting the firm from taking on a new audit client that conducts the majority of its operations outside the U.S., unless such foreign operations are audited by a PCAOB-registered firm, appears to be driven by SEC Chairman Gary Gensler's focus on restrictions on audit inspections of China-based issuers.

This undertaking prevents an audit firm that has violated professional standards and is in the penalty box from auditing an issuer when Chinese regulators may not permit inspection.

Outlook

Heading into 2023, we expect enforcement actions against auditors to increase. This expected uptick in enforcement activity would result from investigations the staff have already commenced, which will take their time to work to resolution.

Also, on Oct. 11, 2022, Paul Munter, acting chief accountant at the SEC, issued a statement titled "The Auditor's Responsibility for Fraud Detection." Munter stated:

As we have emphasized on many occasions, independent auditors play an important gatekeeper role in supporting high-quality financial reporting and the protection of investors [and] a critical aspect of this role is an independent auditor's responsibilities with respect to fraud detection.

Munter announced the Office of the Chief Accountant's view that it has "recently observed shortcomings related to responsibilities over the detection of material misstatements due to fraud that auditors should keep in mind," citing three factors.

First, Munter cited PCAOB observations from inspections.

Second, Munter cited the fact that "[r]ecent Commission enforcement actions against audit firms and their personnel continue to highlight instances of improper professional conduct by auditors with respect to fraud risks."

Third, Munter cited "OCA's discussions with stakeholders [from which] we have heard particularly troubling feedback that auditors many times frame the discussion of their responsibilities related to fraud by describing what is beyond the auditor's responsibilities and what auditors are not required to do."

With respect to that third factor, Munter stated:

We find this attitude of focusing on the limits of the auditor's responsibilities at the outset as opposed to the affirmative requirements with respect to the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud, deeply concerning.

Munter described at length OCA's view of specific auditor responsibilities and good practices to detect fraud.

Our takeaway for SEC enforcement actions against auditors going forward is that the decreased enforcement actions against auditors in 2022 may not be representative of enforcement activity for the coming few years.

As such, we expect to see a reversion to higher activity levels for such enforcement actions in 2023. Alternatively, as a counterweight, the PCAOB has recently discussed increasing its own enforcement

activity against auditors.

It is possible that in the near term the SEC intends to rely more on PCAOB enforcement against auditors for investigations unrelated to broader SEC investigations, which could provide an explanation if SEC enforcement activity against auditors does not return to past levels.

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