The past, present and future of ethics in a challenging environment

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AGENDA

- Who is our public and what does it mean to be an accounting/audit/security professional?
- Professionalism and reputation
- Insider trading
- Cheating
- A world without auditors
- FTX and the crypto “auditors”
- The future of ethics for accounting/audit professionals

WHO IS OUR PUBLIC?

Who is the *public* that accountants/auditors/security professionals must be mindful of?

Licensed, certified public accountants are required by law to maintain the public trust.

This obligation *transcends any employment relationship with their firm or client relationship with a company,* according to the U.S. Supreme Court decision, *U.S. v. Arthur Young & Co.* nearly 40 years ago.

This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

WHO IS OUR PUBLIC?

Are internal and external auditors living up to this standard in an ethical manner and managing the tension between their required public duty and expected professionalism and the attitude towards commercialism required to gain and retain clients or to keep a job?

THE PUBLIC INTEREST IN THE ACCOUNTING PROFESSION

- The Supreme Court noted more than 40 years ago in *U.S. v. Arthur Young & Co*., 465 U.S. 805, 818 (1984) that external auditors play a crucial role in the public company financial reporting process by serving a **"public watchdog function"** that demands **"total independence from the client at all times and requires complete fidelity to the public trust."**

- Auditors need to exercise appropriate professional skepticism, gather sufficient appropriate audit evidence, adequately document work, and, particularly when there are red flags, require more sufficient evidential matter than representations from management.

- Auditors perform a key role in providing a check on management's financial reporting and they must perform that role with a **skeptical eye and appropriate objectivity.**

PROFESSIONALISM

- Perform a public duty
- Be accurate and transparent
- Support your conclusions with sufficient evidence
- Be independent and objective
- Avoid conflicts of interest

THE ACCOUNTING PROFESSION

Professionalism

A licensed profession

There's been a steady drive towards more "professionalization" of audit/accounting, to make it more like law. The MAcc approach created to meet the move to a 150 hours vs. 120 hour requirement for the CPA exam, makes CPA a job that requires an extended course of specialized study like law or medicine, a "learned" profession, that is often automatically considered exempt from overtime.

You may consider a textbook that I contributed a chapter to, one that asked the question: Did the increase in credit hours required to qualify for the CPA exam to150-hours improve ethics in the profession?

(The extra hours were intended to be focused on ethics training and created the ubiquitous Masters in Accounting degree, but doesn't always add significant ethics hours.)

My short answer? No, but that's not because academics aren't trying their damnedest!

DOES REPUTATION RISK DETER AUDITORS AND CPAS FROM WRONGDOING ANYMORE?

In 1990, in the *DiLeo v. Ernst & Young* case related to the failure of Continental Illinois National Bank, the judge expressed a strong belief that an audit firm and its partners will, above all, think about the firm's and their own reputations with the public first:

An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses E & W (now EY) would suffer from a perception that it would muffle a client's fraud*.*

And although the interests of E & W's (now EY) partners and associates who worked on the Continental audits may have diverged from the firm's, covering up fraud and imposing large damages on the partnership will bring a halt to the most promising career. E & W's (now EY) partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. ***It would have been irrational for any of them to have joined cause with Continental.***

Is this still true?

THE ACCOUNTING PROFESSION

Professionalism lost

- **KPMG/PCAOB Scandal**
- **Test cheating scandals (KPMG, EY, PwC)**
- **Accepting engagements with dubious clients (Crypto, sketchy microcap, illegal business models, known criminals)**
- **Lying to regulators (EY US, KPMG UK, multiple non-US firms)**
- **Insider trading**
- **Auditor independence standards/rules violations**
- Backdating documents
- Rolling over on interpretation of accounting standards
- Stealth restatements
- No going concern warnings

Professionalism sold

- Tax avoidance (Panama Papers/Lux Leaks/Paradise Papers) and evasion
  - See where The New York Times quoted me in an investigative piece by Jesse Drucker on how EY developed complex tax avoidance strategies for pharmaceutical company Perrigo and then became Perrigo's auditor when its existing auditor, BDO, would not sign off on them.
- Lack of auditor independence via consulting engagements (prohibited services, lobbying, foreclosure reviews, NYDFS sanctions, system integrations blow-ups)
- Compromised business alliances

INSIDER TRADING

There have been several cases of insider trading by leadership level, high-ranking partners in the largest global audit firms since the Sarbanes-Oxley Act of 2002 was passed.

Those cases should have acted as a deterrent, provided an example to others that not only was such behavior illegal and unethical, but that they would be caught and potentially go to jail.

But, instead, there are more cases of partners and non-partners who didn't get the memo.

INSIDER TRADING

- The SEC and PCAOB have never fined or sanctioned PwC, KPMG, Deloitte or Ernst & Young in any of these cases.
- KPMG did have to resign as auditor from two of Scott London's clients, Herbalife and Skechers.
- In the Chicago-based Thomas Flanagan case, Deloitte paid for the necessary independent investigations to support the firm's claim to clients that it was still independent as an auditor. None of them – Berkshire Hathaway, Walgreens, Sears Holdings among the victims – fired the firm.

ARE THERE ANY CONSEQUENCES FOR CHEATING?

- KPMG partner David Middendorf and PCAOB's Jeff Wada were sentenced to jail terms for their role in the KPMG/PCAOB scandal. David Britt, Tom Whittle, Cynthia Holder and Brian Sweet are also convicted felons because they did illegal things, not because any of them signed an audit report.
- KPMG paid a $50 million fine for the PCAOB scandal and for cheating on tests mandated as a result of SEC consent decree.
- EY paid a $100 million fine for misleading the SEC and allowing cheating on ethics and other CPE tests.
- PwC Canada was been fined more than $900,000 by Canadian and US accounting regulators over exam cheating involving 1,100 of its auditors.
- KPMG's Scott London, Deloitte's Thomas Flanagan, EY's James Gansman went to jail because they took advantage of inside information they obtained via audit firm services.
- The scandal individuals and the inside traders are felons because they did illegal things, whether any investor ever knew their name before.

Was audit quality impacted by the actions?

Did audit clients drop any of the firms as a result of these fines, sentences and sanctions?

Has the reputation and the viability of the profession been affected at all?

Has the "damage to reputations" harmed the firms' business at all?

THE ULTIMATE RISK IF THE PROFESSION DOES NOT FOCUS ON PUBLIC DUTY

The past, present, and future of ethics in a challenging environment

A World Without Auditors

Francine McKenna, who teaches financial accounting at the Wharton School of Business, sees a "pervasive disregard for the seriousness" of such training and testing among audit firm leaders—and that trickles down to staff. "There is no meaning to it. It's something you have to get through," she said.

*…unchecked cheating on ethics tests and other training, coupled with a string of similar cases at other firms, **threatens to undermine a profession that sells itself as a trusted protector of the public's interest, from taxpayers to shareholders.***

The latest news means affiliates of three of the Big Four firms have faced discipline after staff was found cheating on professional training programs since 2019. And EY's record penalty effectively resets the bar for audit enforcement under Gary Gensler's leadership of the Securities and Exchange Commission, which has repeatedly warned firms about risks that threaten their objectivity and cautioned that repeat violations would carry tougher penalties.

It should be "a wake-up call" that the profession can't put profits and client deadlines ahead of auditors' obligations to the public, said Mike Shaub, an accounting professor at Texas A&M University, who teaches ethics and auditing.

"If you're going to compromise your integrity for an exam," Shaub said, "why would people believe you wouldn't compromise your integrity for something that would involve a $10 million fee or a $50 million fee?"

https://news.bloombergtax.com/financial-accounting/ey-cheating-a-wake-up-call-as-sec-targets-market-gatekeepers

THE ULTIMATE RISK IF THE PROFESSION DOES NOT FOCUS ON PUBLIC DUTY

A World Without Auditors

- Theranos and founder Elizabeth Holmes raised more than $700 million from mostly wealthy investors without having to provide anyone financial statements audited by an independent public accounting firm.

The investors duped by the Theranos fraud never asked for one important thing

The last days of Theranos — the financials were as overhyped as the blood tests

- The SEC's complaint against COO Sunny Balwani an investor package with financial projections on spreadsheets created from scratch by Balwani stating Theranos would generate over $100 million in revenues in 2014 and break even. The unaudited financial statements that the SEC said Balwani created also projected Theranos would reach approximately $1 billion in revenue in 2015.
- ***Conspicuously absent from the package are audited income statements, balance sheets and cash-flow statements from a qualified public accounting firm.***
- ***After Holmes trial we now know EY produced audit opinions in the first few years, KPMG was hired to perform audits but never did and switched to consulting, and PwC made millions supporting the windup of the company.***
- ***None of them raised their hand to warn patients or investors.***

THE ULTIMATE RISK IF THE PROFESSION DOES NOT FOCUS ON PUBLIC DUTY

A World Without Auditors

- When auditors don’t look out for the public, everyone gets hurt. The injuries can be more than financial.
- The SEC’s chief enforcer Gurbir Grewal has been asking auditors to step up in almost every speech he’s made since joining the SEC.
- In early December 2021, Grewal asked an audience of audit professionals, CFOs, and other regulators, “Where are the people who are supposed to be counseling folks to play within the guardrails not at the edges of the rules or outside the lines?”
- The SEC’s Grewal can now ask, “Why didn’t any of the global accounting firms who worked for Theranos do their public duty?”

FTX AND THE CRYPTO INDUSTRY "AUDITS"

Do the firms accepting engagements for "audits" and agreed upon procedures attestations have the industry experience and personnel with the necessary competencies required to assess the risk of these new business models, develop new audit methodologies and provide sufficient quality control for their opinions?

In June 2018, Marc Hochstein wrote at Coindesk about the first time Tether produced a third-party report to reassure everyone that its stablecoin, USDT, was fully backed by U.S. dollars. There were some big caveats then, as there still are now.

- Tether, the issuer of the dollar-pegged cryptocurrency USDT, had recently parted ways with an actual audit firm in January 2018 that had been working on an audit, Friedman LLP.
- Friedman had been working on an "audit" of Tether, which has close ties to the cryptocurrency exchange Bitfinex.

In September 2022, Friedman LLP, the New York-based accounting firm that had provided auditing services for the stablecoin issuer Tether in 2017 was accused of "serial violations of the federal securities laws" and "improper professional conduct," by the U.S. Securities and Exchange Commission, which fined the auditor $1 million.

Also in September of 2022 Friedman LP merged with SPAC, microcap, and barred from auditing China companies audit firm Marcum LLP.

FTX AND THE CRYPTO INDUSTRY “AUDITS”

- The firm that succeeded Friedman did not produce an audit report because it was a law firm – Freeh Sporkin & Sullivan, LLP (FSS) – not an accounting firm.
- Even Tether's general counsel said at the time that getting an audit for a crypto firm — an exchange, a stablecoin, to prove that customer assets were protected — was not easy.

"The bottom line is that an audit cannot be obtained," [Stu] Hoegner [Tether's general counsel] told CoinDesk, claiming that this problem is not unique to his company but one faced by the entire cryptocurrency industry. "The barriers to getting audited are simply too big to overcome right now, and not just for us.”

So why did audit firms, and law firms, accept the engagements anyway?

FTX AND THE CRYPTO INDUSTRY “AUDITS”

So why did audit firms, and law firms, accept the engagements anyway? Let’s look at the case of KPMG, its partner John Riordan, and Miller Energy Resources.

KPMG’s Flawed Client Acceptance and Engagement Staffing

21. An accounting firm should establish policies and procedures for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client.

The PCAOB’s quality control standards (“QC”) also require, among other things, that audit firms establish policies and procedures to provide reasonable assurance that each firm appropriately considers the risks associated with providing professional services in the particular circumstances. *See* QC 20.14-.15.

In 2011, KPMG had not established adequate policies and procedures for client acceptance and continuation. Having recently transitioned to a new system for assessing and documenting prospective clients and engagements, KPMG had not established adequate guidance and procedures relating to the use of the new system.

FTX AND THE CRYPTO INDUSTRY “AUDITS”

KPMG’s Flawed Client Acceptance and Engagement Staffing

22. Without adequate guidance and procedures in place, the KPMG engagement team performed an inadequate assessment of the risks associated with the Miller Energy engagement.

Among other things, KPMG’s initial evaluation, which was completed by Riordan and approved by KPMG management, failed to adequately consider ***Miller Energy’s bargain purchase, its recent history as a penny-stock company, its lack of experienced executives and qualified accounting staff, its existing material weaknesses in internal control over financial reporting, its long history of reported financial losses, and its pressing need to obtain financing to operate the newly acquired Alaska Assets.***

As a result, KPMG accepted Miller Energy as a client and incorrectly designated it as a “low” risk client. Based on the information in the initial evaluation, KPMG and Riordan also assigned the Miller Energy engagement an overall risk grade of “medium,” which was not reevaluated and changed to “high” until after KPMG issued its unqualified opinion on the company’s fiscal 2011 financial statements.

FTX AND THE CRYPTO INDUSTRY "AUDITS"

KPMG's Flawed Client Acceptance and Engagement Staffing

23. KPMG's client acceptance procedures also failed to adequately address ***the audit team's lack of industry experience.*** Although a client acceptance evaluation form completed by Riordan noted that the assigned engagement partner and senior manager had no prior experience with oil and gas companies like Miller Energy, it stated that there were no concerns regarding the overall skills and experience of the engagement team.

Consequently, KPMG assigned to the engagement team personnel who had ***insufficient expertise to appropriately address the risks presented by Miller Energy.*** Riordan lacked the necessary experience to serve as the partner-in-charge of the engagement, resulting in departures from professional standards.

24. PCAOB quality control standards state that firms should establish policies and procedures providing ***reasonable assurance that a practitioner-in-charge of an engagement possesses the competencies necessary to fulfill his or her engagement responsibilities.*** *See* QC 40.06. Among other things, these policies and procedures should address whether practitioners-in-charge possess an understanding of the industry in which the client operates. *See* QC 40.08. ***KPMG did not have in place specific policies requiring an assessment of the engagement partner's competencies in the circumstances.***

FTX AND THE CRYPTO INDUSTRY "AUDITS"

It wasn't until 2021 that Coindesk could report that Tether had finally disclosed which assets were backing its stablecoin. However, all was still not yet clear. And the report was from its fifth firm in as many years.

The pie charts provided by Tether made no mention of an independent review by an accounting firm. Moore Cayman, an audit firm in the Caribbean with five employees, published two reports this year attesting that USDT is fully backed. But the auditor (part of the Moore Global confederation of accounting and consulting firms) did not detail what exactly was backing the token.

The new breakdown was the result of Tether's settlement with the New York Attorney General's office (NYAG) after the prosecutor investigated it and its sister crypto exchange Bitfinex over the cover-up of some $800 million in losses. Bitfinex, the parent firm, and Tether paid an $18.5 million dollar fine.

In October 2022, after Tether produced reports from its sixth firm in as many years, BDO Milan, I spoke at the Offshore Alerts Conference in London about whether the reports were helpful, yet.

In response I prepared a comparison of the new BDO Milan reports for Tether and the reports prepared by Grant Thornton for Circle's stablecoin USDC.

FTX AND THE CRYPTO INDUSTRY "AUDITS"

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Item	USDC	Tether
Auditor	Grant Thornton NY (Circle is pre-IPO ad its financial statement auditor is Marcum LLP/Philadelphia.)	Current auditor is BDO Milan. Tether had 5 prior "auditors", including non-accounting/audit law firms before hiring BDO this year.
Timeliness	Last monthly report posted as of Aug 31, 2022	Last quarterly report June 30, 2022.
Type of engagement	We have **examined management of Circle Internet Financial, LLC's assertion that the following information in the accompanying USDC Reserve Report as of August 31, 2022 at 11:59 PM PT is fairly stated**, based on the criteria set forth in the USDC Reserve Report. ⍰ USD Coin ("USDC") in Circulation 1 = 52,258,056,105 USDC ⍰ US Dollars held in custody accounts = $52,430,816,552	"**a reasonable assurance engagement on the Consolidated Reserves Report** of Tether Holdings Limited and its wholly owned subsidiaries Tether International Limited (BVI), Tether Operations Limited (BVI), Tether Limited (Hong Kong), Alpha Group Commodities Limited (BVI) and TG Commodities Limited (BVI) as at 30 June 2022, a copy of which has been included in Appendix 1 to this report."
Division of responsibility	"**Circle Internet Financial, LLC's management is responsible for its assertion.** [GT] responsibility is to **express an opinion on the Reserve Information in the accompanying USDC Reserve Report** based on our examination."	"**Management is responsible for the preparation of the Consolidated Reserves Report** in compliance with the criteria, including Management's Key Accounting Policies, set out in the CRR **and for such internal control as management determines is necessary** to enable the preparation of CRR that are free from material misstatement, whether due to fraud or error."
Applicable Standards	"...attestation standards established by the American Institute of Certified Public Accountants."	"We have complied with the independence and all other **ethical requirements of the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants**...Our company applies **International Standard on Quality Control 1** (ISQC Italia 1)...We carried out our work in accordance with the criteria established in the **International Standard on Assurance Engagements 3000 (Revised) ~ Assurance Engagements Other than Audits or Reviews of Historical Financial Information, issued by the International Auditing and Assurance Standards Board (IAASB) for reasonable assurance engagements...**"
What is objective of auditor's examination?	"...to obtain ***reasonable assurance*** about whether the Reserve Information in the accompanying USDC Reserve Report is fairly stated, based on the criteria set forth in the USDC Reserve Report, in all material respects. An examination involves ***performing procedures to obtain evidence about the Reserve Information."***	"Our responsibility is to express **our conclusion** based on the procedures performed **about the compliance of the [Consolidated Reserves Report] with the criteria, including Management's Key Accounting Policies,** set out therein."
Is an opinion on internal controls expressed?	"...we considered and obtained an understanding of internal control relevant to the preparation of, and the Reserve Information in, the accompanying USDC Reserve Report in order to design procedures that are appropriate in the circumstances, but **not for the purpose of expressing an opinion on the effectiveness of such internal control. Accordingly, no such opinion is expressed.** "	No.
Does the opinion include Management's Notes?	"The Notes to the USDC Reserve Report are provided for additional information. **Such information has not been subjected to the procedures applied in our examination, and accordingly, we do not express an opinion or provide any assurance on it."**	Yes.
Does the auditor's opinion include the breakdown of assets backing the stablecoin?	Yes, Reserve report includes list of CUSIP numbers for US Treasuries and breakdown of proportion of US Treasuries and Cash deposits at "U.S. regulated financial instututions.	Yes, including commercial paper, secured loans, repos, precious metals andTether Gold tokens.
Does the auditor's opinion include a list of financial institutions where cash deposits are held?	**Yes, but the list is in the management Notes which are not audited.**	**No.**
Did the auditor perform confirmations of balances and securities held at third party institutions?	**No,** these representations are in the management Notes which are not audited.	**Yes.** "Specifically, we carried out the following procedures: ...4) obtain confirmation letters directly from banks and depositaries and verify the reconciliations performed by management between the amounts in the accounting ledger/system and the bank statement to confirm the existence of the assets disclosed in the CRR; 5) verify, on a sample basis, the correct valuation of the assets disclosed in the CRR in accordance with the criteria described in the Management Key accounting policies; 6) verify the reconciliations performed by management between the accounting ledger/system and the ledgers on the various blockchains relating to assets and liabilities at 30 June 2022; 7) verify, for a sample of outstanding secured loans, the existence of the collateral through the analysis of the contract and of the transactions; 8) verify the correctness of the disclosures included in the CRR, excluding the Notes included in Appendix 2.
Did the auditor obtain evidence of compliance with customer asset segregation representations?	**No,** these representations are in the management Notes which are not audited.	No mention of the status of customer segregation of assets from corporate assets.
Other Comments from auditor?	**No.**	**Yes,** a Scope Limitation paragraph and extensive Emphasis of Matter section with limitations and risks, including litigation and timing risks.

FTX AND THE CRYPTO INDUSTRY "AUDITS"

Which brings us to FTX

On Nov 17, 2022 the WSJ came out with a story mentioning that FTX had been "audited" but the firms were more like cheerleaders than watchdogs.

When FTX faced a liquidity crunch, the auditor of its U.S. unit seized the moment to promote its services for other crypto companies that were under the spotlight.

It is a "great time to remember" Armanino LLP's specialized crypto assurance, the firm tweeted last week, referring to a product that verifies customer assets held by crypto firms.

When FTX's former chief executive, Sam Bankman-Fried, gave evidence to a congressional committee in December, the firm, which is in the Top 20 firm by revenue, cheered him on. "Let's go buddy!" the firm tweeted.

There is a race among crypto brokers, lenders and exchanges to calm their anxious clients by getting the blessing of an auditor. ***But the type of audits they are getting and the collapse of an audited firm such as FTX shows how far that sector is from a traditional regulated, scrutinized industry.***

FTX AND THE CRYPTO INDUSTRY "AUDITS"

I wrote** for Coindesk on November 18 **about what the FTX audits by Armanino and Prager Metis missed.

Nine days after an FTX liquidity problem became a crisis when sharp reporting by Ian Allison at Coindesk on Nov. 2 exposed the FTX "house of cards" the company filed for bankruptcy.

CoinDesk obtained the audited financial statements of West Realm Shires, also known as FTX US, and FTX Trading Ltd., the offshore Bahamas-based entity that includes an exchange catering to non-U.S. customers.

We found out later via the bankruptcy court filings that a separate proprietary trading firm, Alameda, has apparently never been audited.

We know what the limited assurances that check assets backing stablecoins like Tether and USDC miss.

What did the FTX financial audits miss?

FTX AND THE CRYPTO INDUSTRY "AUDITS"

In an essay for CoinDesk, I laid out a series of missteps in FTX's auditing process. The blowup of Sam Bankman-Fried's empire was like a meteor striking the crypto world, but foreseeable "if you knew where to look in the audited financial statements."

- **The first red flag** was two audit firms. "Why hire two different firms rather than one to produce an opinion on consolidated results? With the benefit of hindsight, we can see it perhaps suggested that Bankman-Fried didn't want any firm to see the whole picture." Armanino and Prager Metis have little experience auditing large enterprises, compared to Big Four global firms that have a history of working with such clients. (Deloitte and PwC acted as "advisors" to FTX but we don't know what they were doing.)

  No one has significant experience working with crypto exchanges and there are no accounting standards for these transactions. (That's why Deloitte's role as auditor of Coinbase and advisor to Microstrategy is so important!) Since the crypto business models are unregulated, they do not comply with disclosure standards for custody, capital or customer segregation. The PCAOB has extensive guidance for auditors of broker-dealers and custodians. We see none of the extra compliance and assessment reporting.

- **A second red flag** was that neither Prager Metis nor Armanino "provided an opinion on the FTX US or FTX Trading internal controls over accounting and financial reporting. FTX's new CEO, restructuring expert John J. Ray III, told the bankruptcy court: "There were no controls."

- **A third red flag** was that neither FTX Trading or FTX US paid federal income taxes, although both appeared to be profitable.

- **The biggest red flag** "should have been the number of complex, roundtrip and utterly confounding related-party transactions documented in just these two years."

FTX AND THE CRYPTO INDUSTRY “AUDITS”

The FTX fiasco forced Binance, Tether, KuCoin, and several other offshore unregulated exchanges such as Crypto.com to up their game on reporting on how well stablecoins and customer account balances were backed.

However, since then, FTX audit firms Armanino and Prager Metis have said they did not continue to work with FTX after the 2021 audit opinions.

Armanino has also now announced it is shutting down its crypto audit practice.

FTX CEO John Ray threw the FTX auditors to the wolves:

> *I have substantial concerns as to the information presented in these audited financial statements, especially with respect to the Dotcom Silo. As a practical matter, I do not believe it appropriate for stakeholders or the Court to rely on the audited financial statements as a reliable indication of the financial circumstances of these Silos.*

FTX AND THE CRYPTO INDUSTRY "AUDITS"

Binance issued a report on Dec. 7. Coindesk's Helene Braun wrote:

The collapse of centralized crypto exchange FTX because of liquidity issues has rivals rushing to improve the transparency of their financial reserves. The report from Mazars was meant to assure customers that their bitcoin is collateralized, exist on the blockchain and is in Binance's control.

However, the assessment is not an official audit, according to Francine McKenna, lecturer in financial accounting at The Wharton School at the University of Pennsylvania. "They did a comparison of balances per public key address from a list they got from management. They did not compare any balances in independent banks or custodians or depositories," said McKenna. "This is more worthless than even the Tether or USDC report," she added.

On Dec. 9, Braun wrote that Crypto.com and KuCoin had followed Binance by also releasing proof-of-reserves data in reports prepared and signed by the South African member of audit firm Mazars that purported to prove customers' assets were fully reserved for. I was doubtful the reports actually provided any assurance, literally or figuratively. It came after rival exchange Binance released a similar report from the same auditor seemingly proving its reserves on Wednesday.

The report was not an actual audit, but a "matching exercise based on information provided by the client about on-chain addresses of assets and a client database of customer balances," according to Francine McKenna, lecturer in financial accounting at the Wharton School at the University of Pennsylvania. "It is no better than the Binance report, which is not surprising since it is the same firm and partner doing it."

FTX AND THE CRYPTO INDUSTRY "AUDITS"

Barely a week later the Mazars report on Binance's bitcoin assets had been pulled from Binance's site as of Friday Dec. 16. BDO is also reportedly "reevaluating" its work for crypto firms, including Tether, according to the WSJ.

> "In common with several other professional service firms, we are currently evaluating our approach to this sector and the work we undertake for our clients," a spokesman for the BDO international network said.

So what's really going on? What does it really mean when auditors bail out loudly? Interestingly, the last time Mazars bailed out on a client very loudly it was from its years of work for Donald Trump.

Messages about the mess that are these non-audits, delivered via media and private comments, do lead to regulators' whispers in the ears of the heads of some audit firms, I said on Dec 20 in a newsletter at *The Dig*.

I was right!

FTX AND THE CRYPTO INDUSTRY “AUDITS”

Two days later, on Dec 22, the WSJ published an interview with SEC Chief Accountant Paul Munter:

- WSJ News Exclusive Cryptocurrency
- ***SEC Heightening Scrutiny of Auditors’ Crypto Work***
- ***Regulator concerned about cryptocurrency companies overstating audit firms’ narrow reports***

The Securities and Exchange Commission is stepping up scrutiny of the work that audit firms are doing for cryptocurrency companies, concerned that investors may be getting a false sense of reassurance from the firms’ reports, a senior official at the regulator said.

“We’re warning investors to be very wary of some of the claims that are being made by crypto companies,” Paul Munter, the SEC’s acting chief accountant, said in an interview.

Increased scrutiny has led at least one audit firm to drop crypto clients, in some cases soon after producing reports on the companies’ assets and liabilities. Crypto companies are eager to get the blessing of an auditor to reassure their skittish clients.

The Wall Street watchdog is looking closely at how crypto companies are portraying their reports from audit firms, according to Mr. Munter. Many of these companies are closely held or based offshore, and so unlikely to fall within the regulator’s remit. ***The SEC is effectively sending a warning to audit firms, which don’t want to run afoul of their regulator, as well as putting investors on alert.***

The regulator is worried particularly about so-called proof-of-reserves reports, which aim to show that the crypto company has sufficient assets to cover customers’ funds. Companies have rushed to produce these reports in recent weeks, using the credibility of audit firms to try to reassure customers spooked by the collapse of crypto exchange FTX.

THE FUTURE OF ETHICS

The past, present, and future of ethics in a challenging environment

It's a myth that the largest global audit firms will avoid doing anything that harms their reputation, and will police their own to make sure any professionals that bring shame on the profession by committing illegal and unethical acts are fired, not rewarded, and will never audit or give advice ever again.

Why? Regulators say they can't run the risk of putting another big firm like Arthur Andersen out of business, Barbara Roper says. But by being unwilling to hold the firms fully accountable for repeatedly defying the law and compromising the integrity of audits, regulators like SEC Chairmen Clayton, Gensler, and their predecessors, send the message the Big 4 firms can operate with impunity. **They are not just too big to fail, they are truly too few to call to account.**

It's also myth that most CPAs worry about their professional reputation and avoid doing anything that harms it, in fear that for a profession based on trust they will never get hired again.

It's not a given that partners who cause the firms to be sued get fired or even ones that are criminally convicted forfeit their retirement benefits. Just look at partners like these and the KPMG scandal partners or almost any partner convicted and jailed for insider trading. The firms often keep partners that cause the firm to be sued on board , friends close, enemies closer you see. Seemingly disgraced partners land on their feet at clients, often as a favor to their former firm.

THE FUTURE OF ETHICS

The past, present, and future of ethics in a challenging environment

Scandals are a cost of doing business. For example, scandals and frauds that should have severely dented auditors reputation in the public eye, there was little impact on the firms from a business perspective.

For example…KPMG was not debarred from federal contracts after its guilty plea and record fine for tax shelter crimes in 2005 that almost resulted in a criminal indictment that would have been an Andersen-like death penalty. Research shows KPMG lost no clients as a result of the top of its audit practice in the US being convicted of criminal conspiracy and wore fraud.

Some say that however well-taught they are by well-meaning academics fresh university graduates have basic DNA no different — for better or worse — than their peers elsewhere. Although gaining the license and obligations of CPAs “they are not bestowed with any special aptitude for skepticism beyond the normal, nor a super-human capacity to overcome the universal susceptibility to non-benign influence.” Jim Perterson in The Dig.

Does the carrot of incentives or the stick of punishment work? Can on-the-job training or compliance exercises such as ethics signoffs eliminate the impairing effect of compromising influences such as the stresses of budgets and workloads, peer pressures, or “go along” signals from their immediate supervisors? KPMG’s test cheating occurred after their colleagues were arrested for the PCAOB data stealing scandal!

Self-interest and immediate incentives are strong motivations to forget education and training if it landed on fertile ground at all. There *will be* cheaters in any human-run system.

FURTHER READING

- "Corruption in the Auditor Inspection Process: The Case of KPMG and the PCAOB," Teaching case forthcoming in *Issues in Accounting Education.* With Pevzner, Mikhail; Sheneman, Amy; and Zach, Tzachi.

- *IT Control Objectives for Sarbanes-Oxley: Using COBIT® 2019 in the Design and Implementation of Internal Controls Over Financial Reporting*, 4th Edition Co-author with Dina Nu'man.

- "Have Advanced Degrees Increased Ethical Professionalism for Auditors?" in *The Routledge Handbook of Accounting Ethics*. Taylor, Eileen Z., and Paul F. Williams, eds. Routledge, 2020.

- "Economic Consequences of Auditor Reputation Loss: Evidence from the Audit Inspection Scandal" with Pevzner, Mikhail; Sheneman, Amy; and Zach, Tzachi. Working paper

- *Bad Blood* by John Carreyrou on the origins of the Theranos medical fraud.
- *The Politics of Financial Risk, Audit and Regulation: A Case Study of HBOS* by Atul K. Shah
- *Billion Dollar Whale; The Man Who Fooled Wall Street, Hollywood, and the World* By Tom Wright and Bradley Hope He also fooled three of the four Big 4 firms, or did he?
- *The Wizard of Lies* by Diana Henriques about the Madoff fraud from a psychological perspective.
- *A Guide to Forensic Accounting Investigation*, Thomas W. Golden, Steven L. Skalak, and Mona M. Clayton
- No individual prosecutions during crisis – Jesse Eisinger's *The Chickenshit Club* has a great chapter why everyone uses Arthur Andersen as an excuse for not indicting firms or high ranking executives.
- Jim Peterson's book second edition, *Count Down: The Past, Present and Uncertain Future of the Big Four Accounting Firms*, is great for understanding the background, the law, and the history of the profession and impact on why things are they way they are today.

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