



OPERATION BROKEN GATE

THE SEC IS HOLDING GATEKEEPERS ACCOUNTABLE.

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In September 2013, the U.S. Securities & Exchange Commission (SEC) announced charges against three auditors for “violating federal securities laws or failing to comply with U.S. auditing standards during their audits and reviews of financial statements for publicly traded companies.” The charges came about as part of Operation Broken Gate, an initiative by the SEC to provide tighter oversight of individuals it considers to be the “gatekeepers” for protecting investors by helping ensure fair financial presentation and disclosure by public companies.

Subsequent public statements from SEC officials, including SEC Chair Mary Jo White, indicate that the SEC's oversight of those responsible for providing assurance of the accuracy of disseminated public company financial information will become significantly more stringent and encompassing. It's also clear that this initiative promises closer scrutiny, not only of auditors but of all parties who bear fiduciary responsibility as the gatekeepers of fair public company financial reporting—including audit committees, CEOs, CFOs, and other responsible parties within public companies.

The reasons for the initiative aren't known. After the Bernie Madoff scandal, the SEC was criticized for neglecting to protect the many investors who suffered massive losses, and Operation Broken Gate could be an effort to prevent further large-scale frauds. Another possibility is the consolidation of the largest accounting firms and the mistaken perception of some that the Big 4 public accounting firms are simply "too big to fail"—and Operation Broken Gate is a statement that no audit firm, regardless of size, is to be overlooked. Whatever the motivation, the impact will extend beyond auditors, and understanding the scope of the SEC's enforcement initiative and increased level of scrutiny will help companies anticipate possible areas of difficulty and plan strategies to help ensure they—and their auditors—don't run afoul of the SEC.

Expect Increased Enforcement

Describing the SEC's enforcement program in an October 2013 speech, White stated her conviction that "investors in our markets want to know that there is a strong cop on the beat—not just someone sitting in the station house waiting for a call, but patrolling the streets and checking on things... They want someone who understands that even the smallest infractions have victims." She further noted that in order to achieve that level of SEC enforcement surveillance, "It is important that we strive to be everywhere to enforce our securities laws and to protect investors," adding that "striving to 'be everywhere' is finding a way to have a presence that exceeds our physical footprint and to be felt and feared in more areas than market participants would normally expect that our resources would allow."

White also emphasized the ramifications for auditors from this enhanced SEC vigilance by noting that one purpose of Operation Broken Gate was to "identify auditors who neglect their duties and the required auditing standards." She finished with a warning that auditors should

expect to see more cases similar to the initial three.

The SEC's introduction of Operation Broken Gate signals a more vigorous focus on enforcement action that is directed not only at auditors but also at audit committee members and all others (such as company management) who fail in their fiduciary responsibilities to investors as gatekeepers of fair financial reporting by public companies. In a speech in September 2013, SEC Co-Director of the Division of Enforcement Andrew Ceresney stated that "if there is a significant restatement or if we learn about improper accounting... you can expect that we will scrutinize not only the CEO, CFO and Controller, but also the engagement partner, engagement quality reviewer, and the auditing firm as a whole." The increased scrutiny of gatekeepers implied by this and other statements from SEC officials indicates a changing landscape when it comes to the responsibility and risk borne by auditors, lawyers, audit committee members, board members, and management.

Initial Enforcement Actions

The SEC's website includes a database of chronological, sequentially numbered Accounting and Auditing Enforcement Releases (AAERs) that provides "financial reporting related enforcement actions concerning civil lawsuits brought by the Commission in federal court" (www.sec.gov/divisions/enforce/friactions.shtml). AAERs may target audit firms and individual auditors who fail to comply with U.S. auditing standards and thereby put investors at risk from undetected fraudulent financial reporting and misstatements by publicly traded companies. Audit firms and individual auditors appearing in an AAER can incur civil monetary penalties, lose the privilege of practicing before the SEC, and experience significant damage to their professional reputation.

The September 30, 2013, announcement that first referenced Operation Broken Gate involved AAER Nos. 3501, 3502, and 3503. Two of the auditors settled their cases and are prohibited from practicing as accountants on behalf of any publicly traded company, while the third auditor was ordered to appear for a public hearing before an administrative law judge.

Two months after White's warning that there will be more cases, the SEC released its report of enforcement actions for fiscal year 2013. The report contained a section called "Gatekeepers," which referenced SEC charges against "the Chinese affiliates of major accounting firms [including each of the Big 4 and another large U.S. accounting firm] for refusing to produce documents relat-

Table 1: PCAOB Quality Control Defects and Related SEC Charges Against Auditors/Gatekeepers under Operation Broken Gate

NUMBER OF FIRMS	QUALITY CONTROL CATEGORY	POTENTIAL AAER CHARGES AGAINST AUDITORS/GATEKEEPERS
68	Audit Performance: Technical Competence, Due Care, and Professional Skepticism	<ul style="list-style-type: none"> • (The auditor) does not possess the degree of skill commonly possessed by other auditors. • Failed to exercise due professional care.
45	Audit Performance: Concurring Partner Review	<ul style="list-style-type: none"> • Failed to obtain required engagement quality reviews. • (The auditor) was not competent to serve as the engagement quality review partner.
40	Audit Performance: Auditor Communications	<ul style="list-style-type: none"> • Failed to make required communications to the audit committee. • Failed to make required communications with the predecessor auditor. • Failed to obtain written management representations.
28	Independence and Independence Procedures	<ul style="list-style-type: none"> • (The auditor) was not independent with respect to the audit services.
22	Audit Performance: Appropriate Procedures	<ul style="list-style-type: none"> • (The auditor) did not control the confirmation process.
13	Audit Performance: Fraud Procedures	<ul style="list-style-type: none"> • Failed to consider fraud risks.
11	Audit Performance: Testing Appropriate to the Audit	<ul style="list-style-type: none"> • Failed to evaluate whether uncorrected differences were material.
11	Monitoring and Addressing Identified Weaknesses	<ul style="list-style-type: none"> • None of the work papers contained evidence indicating who has performed the work and the date such work was completed.
10	Audit Performance: Engagement Completion Document	<ul style="list-style-type: none"> • Failed to prepare an engagement completion document.
7	Documentation (i.e., insufficient competent evidence obtained)	<ul style="list-style-type: none"> • Failed to prepare and retain adequate audit documentation. • Failed to obtain sufficient competent evidential matter.
26	Other (e.g., disclosures, training, client acceptance, subsequent events, etc.)	<ul style="list-style-type: none"> • Failed to evaluate and assess the adequacy of the issuer's disclosure of related party transactions.
281	Total Number of Defects	

This table presents a summary of the number of quality control defects in the first publicly disclosed PCAOB inspection reports of smaller firms as of November 2012 and suggests possible charges that the auditors might face under the SEC's Operation Broken Gate. Source: James F. Boyle, Douglas M. Boyle, Dana R. Hermanson, Richard W. Houston, "Quality Control Defects in Smaller Firms' PCAOB Inspection Reports," *The CPA Journal*, June 2013.

ed to China-based companies being investigated." And the auditors weren't the only ones facing charges: Trustees and directors were also charged by the SEC for "failing to uphold their responsibilities under securities laws."

In this instance, the SEC charged the audit firms with "willful refusal to provide the Commission with audit work papers in violation of their obligations under Section 106 of the Sarbanes-Oxley Act." AAER No. 3553, issued on May 9, 2014, upheld the judge's initial decision regarding the auditors' willful refusal to provide work papers and deemed immaterial the claim that providing such work papers violated Chinese law. It was further determined that barring four auditors from the privilege of practicing before the Commission was warranted.

Strengthening Enforcement

When enforcing securities laws, the SEC can impose fines, revoke or suspend licenses, seek injunctions, and

even refer individuals for criminal prosecution. But the SEC itself doesn't have the direct power to jail wrongdoers. Comments from White appear to suggest that the SEC will be working more closely with other oversight bodies and government authorities to impose greater (or additional) penalties and consequences within Operation Broken Gate.

During a March 2014 videoconference, White stated that "in order for our SEC enforcement program...to be effective, the punishment must not only fit the crime, but the actions we bring must send a strong message of deterrence to other would-be wrongdoers...It has not been atypical in recent years in the United States to see CEOs convicted of securities fraud to be sentenced to 20-plus years in prison. That sends an undeniable message of deterrence." White's intentions to vigorously pursue sanctions against wrongdoers were further underscored when she expressed her desire to "enlarge [the SEC's] enforce-

ment footprint with a renewed focus on gatekeepers,” and lamented that the SEC “civil penalty authority is not as strong as [she] would like it to be.” White indicated that “to broaden our own enforcement reach, we also leverage our efforts by working in parallel with criminal authorities, like the United States Department of Justice, who do have the power to jail wrongdoers and to obtain higher monetary penalties.”

When trying to identify areas and issues that might see increased scrutiny, one place to look is the Public Company Accounting Oversight Board (PCAOB). At a February 2014 SEC Open Meeting about the PCAOB, SEC Commissioner Luis A. Aguilar noted that investor confidence in the reliability of public company financial statements depends on the rigor of high-quality, independent audits. To that end, he expressed his support of the PCAOB’s budget and the accounting support fee in order to provide the PCAOB with sufficient resources to fulfill its mission. Aguilar referenced PCAOB reports that identify high levels of deficiencies in audit performance and quality control and declared that “the status quo is unacceptable.” He concluded his remarks by noting that “success must be measured by significant and sustained reductions in the number of audit deficiencies identified through the inspection process.”

The audit failures noted in AAERs under Operation Broken Gate include matters that commonly appear in PCAOB inspection reports as quality control defects. This suggests that issues that were previously treated as quality control defects may now also be grounds for an SEC investigation. To show what that might entail, Table 1 presents a summary of the 281 quality control defects found in the first publicly disclosed PCAOB inspection reports for 107 smaller firms (i.e., firms that audit 100 or fewer public companies) as of November 2012. We matched each defect with a corresponding charge that was made against the auditors and other gatekeepers in the first three AAERs under Operation Broken Gate. There is a clear similarity between charges in the AAERs and the quality control defects appearing in PCAOB inspection reports.

Looking at prior SEC enforcement actions, a 2013 study by Mark Beasley, Joseph Carcello, Dana R. Hermonson, and Terry L. Neal titled “An Analysis of Alleged Auditor Deficiencies in SEC Fraud Investigations: 1998–2010” examined a total of 87 U.S. public company fraudulent financial reporting investigations leading to SEC sanctions against auditors over the period of 1998–2010. Six of the cases involved “bogus audits” where there were no

meaningful audit procedures performed at all. Of the remaining 81 cases, 35 involved audits performed by national firms, which includes the Big 6/Big 4 firms and the next tier of large firms such as present-day Grant Thornton, LLP; BDO, LLP; Crowe Horwath, LLP; and McGladrey, LLP. The other 46 cases involved smaller, more regional firms.

The SEC charged the auditor for violating antifraud statutes—in other words, for participating in the fraud—in 24 of the 81 cases. In 80 out of the 81 cases, the SEC issued sanctions against the individual auditors. And in 26 of those cases, the audit firm also was subject to sanctions. In one case, only the audit firm was sanctioned. The top five primary deficiencies in the actual audits of the 81 companies are:

1. Failure to gather sufficient competent audit evidence (73% of cases).
2. Failure to exercise due professional care (67% of cases).
3. Insufficient level of professional skepticism (60% of cases).
4. Failure to obtain adequate evidence related to management representations (54% of cases).
5. Failure to express an appropriate audit opinion (47% of cases).

Considering the few SEC sanctions against auditors in public company fraud cases between 1998 and 2010, the number of SEC sanctions against auditors under Operation Broken Gate suggests that auditors may find themselves defending any allegations of below-standard public company audit work in federal courts as part of AAERs rather than—or in addition to—remediating quality control defects as part of the PCAOB inspection process.

Implications for Gatekeepers

It seems apparent that the SEC has embarked on an agenda focused on the scrutiny of auditors, audit committee members, and other gatekeepers. Less apparent is the fact that Operation Broken Gate also has great significance to preparers of corporate financial statements. The implications to the preparers and auditors are, in fact, closely intertwined since SEC charges of auditor deficiencies and allegations of fraud will impact the client company and its stockholders.

The company often faces more costly audits due to the additional procedures (involving both the audit firm and accounting staff within the organization) required to “correct” the deficiencies. And arguably of

greatest significance to the company are the costs associated with any reduced confidence in the audited financial statements on the part of the company's shareholders, creditors, and other financial statement users. The financial markets can react quite dramatically to reports of audit deficiencies/failures. For example, Carol Callaway Dee, Ayalew Lulseged, and Tianming Zhang found that there was a significant negative stock market price reaction for clients of Deloitte and Touche, LLP following news of the PCAOB sanctions imposed on Deloitte on December 10, 2007, related to its audit of Ligand Pharmaceuticals Incorporated ("Client Stock Market Reaction to PCAOB Sanctions Against a Big 4 Auditor," *Contemporary Accounting Research*, Spring 2011).

It's therefore more important than ever that everyone involved understands the importance of their respective roles and responds appropriately. The quality control defects and AAER charges listed in Table 1 can be used to raise awareness about the issues of critical importance to the PCAOB and the SEC. Auditors might use this information to identify and remove potential gaps in quality control programs and ongoing training efforts. Audit committee members can use it to better determine the kinds of inquiries they should be making of management and the external auditors and to help auditors in the planning and performance of their essential audit work. It would also be useful in determining the kinds of inquiries they should be making of management and the external auditors.

CFOs, controllers, and management accountants can use the information when monitoring the performance of the company's independent auditors and thus help ensure that a diligent and quality audit is performed. This should minimize audit costs and avoid negative publicity. It also enables management to fulfill its obligations under the Sarbanes-Oxley Act of 2002, such as the Section 404 requirement that management assesses the effectiveness of internal controls over financial reporting and the Section 302 requirement that senior management certifies that the financial statements are fairly reported. Finally, management accountants who ensure that the independent auditor is exercising due diligence in the performance of the audit will likely gain the support of the company's audit committee, who will in turn view the company's own accountants as trusted partners in promoting fair financial reporting.

Furthermore, the AAERs charges listed in Table 1 can be used as an audit quality performance checklist by CFOs,

controllers, and management accountants. While it may not be possible to have the company's accounting professionals conduct a complete review of the audit firm's adherence to audit standards, internal accountants (including internal auditors) should assess the completion of key audit performance responsibilities by the independent audit firm. For example, the required degree of auditor skill can be assessed during the course of the audit. The controller's questions about the opinions and judgments of the audit engagement quality review partner may be asked as a means of assessing the quality (or lack thereof) of the review partner. The auditor's required communications with the audit committee should also be verified. Finally, certain "red flags," such as the auditor not controlling the confirmation process, should be monitored and acted on as they frequently serve as signals of a deficient audit.

The recent expansion of SEC scrutiny to all parties deemed responsible for fair and accurate financial reporting requires renewed diligence not only by auditors but by all who play a role in the public company reporting process. Such renewed diligence applies no less to the preparers of financial statements than to independent auditors. Accordingly, CFOs, controllers, and all of the other internal participants should take the kinds of proactive measures that help preempt audit deficiencies and the resulting damage to their companies. Keeping abreast of audit problems that bring negative publicity to other public companies can help management accountants maintain a positive image for their own companies. **SF**

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