

PCAOB Case Expands Legal Exposure For Audit Failures

By Robert Cox (April 3, 2018, 3:21 PM EDT)

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A defense of an audit engagement partner that he or she cannot be personally liable for deficient work the partner did not personally perform is no longer viable after a recent decision by the Public Company Accounting Oversight Board. An engagement partner who delegates audit work to assistants cannot limit his or her liability for audit failures to only audit work that the auditor personally performed, such as planning the audit and supervising the work of other members of the engagement team. The engagement partner acts throughout the audit as the auditor with final responsibility for the audit and must engage in a continuous process of gathering, updating and analyzing information throughout the audit. If the partner identifies shortcomings in the audit, he or she is responsible for directing his or her assistants to address them or personally perform necessary procedures to obtain the required audit evidence.

In a recent adjudicated decision, *In the Matter of Melissa K. Koepfel, CPA*,^[1] the PCAOB rejected an auditor's variation of the "Ken Lay" defense^[2] that she should not be liable for the failure of assistants to perform necessary audit procedures to obtain required audit evidence. Melissa K. Koepfel, a Grant Thornton LLP, or GT, partner, had prevailed before a PCAOB hearing officer (equivalent to an administrative law judge) on the theory that she could not be held liable for engagement team members' violations of PCAOB rules and auditing standards where she, herself, did not perform any audit work that violated PCAOB auditing standards. Because she had not performed the deficient audit work and the PCAOB Division of Enforcement and Investigations

had not charged her with failing to plan or supervise the work, the hearing officer held that the division had not "established a legally cognizable basis" for imposing sanctions on Koepfel. In reversing the hearing officer, the board held,

The overall point is that she took no corrective action of any kind in response to the facts about the audit work the Division alleges were known to her. We hold that her role as the auditor with final responsibility for the audits does not have the effect of insulating her from a finding that she violated the specific rules and standards charged in the OIP if the evidence establishes the facts alleged in the OIP.^[3]

Background

Koepfel was a GT partner in the Milwaukee office and served as the office's managing partner from 2008 to 2011. From 2002 to 2008, Koepfel served as the office audit practice leader, in charge of overseeing the audit practice and training.^[4]

Koss Audits and Fraud

Koepfel was the auditor with final responsibility, or engagement partner, for GT's audits of the financial statement of Koss Corp. for the fiscal years ending June 30, 2006, 2007 and 2008. Koss manufactures and sells stereo headphones and accessories.

In late 2009, Koss disclosed that its financial statements should no longer be relied upon because of the discovery of unauthorized financial transactions that were the subject of an internal investigation.^[5] In a June 30, 2010, Form 10-K/A, Koss disclosed that the vice president of finance had been engaged in misappropriation of

millions of dollars through unauthorized transactions involving wire transfers and cashier's checks to pay the vice president's personal expenses, in circumvention of Koss' internal controls and other operating procedures.^[6] Koss restated its financial statements for fiscal years 2008 and 2009, principally to reflect adjustments relating to the fraudulent transactions totaling approximately \$31.5 million.^[7]

PCAOB Charges Koeppel

The PCAOB enforcement division charged Koeppel with violating PCAOB rules and auditing standards for the annual audits for fiscal years 2006, 2007 and 2008.^[8] At issue as to each audit was the testing of Koss' journal entries for potential material misstatement due to fraud and audit work on particular issuer accounts into which journal entries flowed.^[9] Koeppel delegated the performance of the audit procedures to junior members of the engagement team and supervised the performance of the procedures by reviewing the audit work performed by team members. Koeppel was charged with failing to exercise due professional care, including professional skepticism, failing to obtain sufficient audit evidence and assurance, and other violations.^[10] For reasons not explained in the decision, the division did not charge Koeppel with failing to plan, delegate or supervise that audit work. For the audit years at issue, AU Section 311, Planning and Supervision, was the auditing standard applicable to planning and supervision of the audit.^[11]

The Hearing Officer Finds Koeppel Is Not Liable for Deficiencies in Audit Work She Did Not Perform

In the hearing before the PCAOB hearing officer, Koeppel argued that as an engagement partner who delegated the performance of audit procedures, she could only be charged with violations under AU Section 311. The hearing officer found that the enforcement division proved that some of the audit work did not fully comply with applicable PCAOB auditing. Because the division had not charged her with violations of AU Section 311, the hearing officer found that the division had not established a legally cognizable basis for imposing sanctions on Koeppel.

The Board Rejects Koeppel's Liability Argument and Finds Liability for Multiple Acts of Negligence

On appeal, the board conducts a de novo review of the decision of the hearing officer and the evidentiary record. The board overturned the initial decision of the hearing officer and found that Koeppel violated PCAOB rules and auditing standards by failing to exercise due professional care, including professional skepticism, and failing to obtain audit evidence, among other violations in the audits of Koss Corp. Koeppel's principal arguments on appeal were: (1) when an engagement partner delegates audit work to assistants, she is only liable for violations of the auditing standard for supervision, AU Section 311; and (2) holding her liable for the acts of assistants would be under a theory of strict or vicarious liability.

As to Koeppel's first liability argument, the board rejected "Koeppel's reductionist, binary approach, in which an engagement partner either performs detailed audit procedures in the first instance or has nothing but a supervisory role to play in the audit."^[12] As the auditor with final responsibility for the audits, the board held that Koeppel had the capacity and responsibility to act in multiple roles in the audit and cannot limit her responsibility to a purely supervisory role.^{[13][14]} When she or her assistants failed to obtain the required evidence or assurance or ensure that procedures were performed to obtain such evidence, Koeppel directly violated various auditing standards when she failed to perform necessary audit procedures herself or asked her team to perform the procedures to obtain the required audit evidence.^[15] The board stated, "[i]nert passivity in the face of known facts constituting shortcomings in the audit does not insulate the partner from liability, simply because that inaction might be viewed, but is not charged, as deficient supervision."^[16]

As to Koeppel's second argument, the board held that Koeppel's liability for direct violations of PCAOB auditing standards is not under a theory of strict or vicarious liability, where a principal is held liable for the acts of her agent. "Finally, contrary to Koeppel's claims ... this case is not about strict or vicarious liability, under which sanctions could be imposed on her for an act, practice, or omission of someone else, irrespective of the circumstances of her own conduct."^[17] The division's charges were based on Koeppel's own conduct, not the conduct of other engagement team members. Koeppel made no effort to address deficiencies in the audit work she learned in her review of work papers through either

(1) directing assistants to perform additional work to gather audit evidence; or (2) personally performing the additional work required to support the audit opinion.^[18]

In 2015, the SEC Sanctioned GT, Koepfel and Another Partner for Similar Violations on Other Audits

Koepfel is a repeat offender who GT removed from public audit engagements as a result of an internal quality review. In a Dec. 2, 2015, order against GT and a separate order against Koepfel and Jeffrey J. Robinson, CPA, the U.S. Securities and Exchange Commission settled charges against the respondents for ignoring red flags and fraud risks while conducting deficient audits of two public companies that filed materially false and misleading reports with the SEC.^[19] Koepfel was the engagement partner on the deficient audits of both companies. GT admitted to the violations, was fined \$3 million, and agreed to forfeit \$1.5 million in audit fees. Koepfel was denied the privilege of appearing or practicing before the SEC as an accountant for five years and fined \$10,000.^[20]

Key Takeaways

The Engagement Partner Has Direct Liability for Auditing Standards Violations

Following Koepfel, an engagement partner cannot insulate herself from a finding that she violated the specific rules and standards by delegating the performance of audit work to subordinates. Section 105(c)(6) of the Sarbanes-Oxley Act creates a new ground of liability based on the engagement partner's fundamental, nondelegable responsibility as the auditor with final responsibility for the audit.^[21] The engagement partner must act with due care to see that the audit team "performs all of the audit procedures that are required under the circumstances by PCAOB auditing standards, obtains reasonable assurance that the financial statements under audit are free of material misstatement, and obtains sufficient competent evidential matter to afford a reasonable basis for the audit opinion."^[22] Koepfel increases the legal exposure of an engagement partner for audit failures.

Sanctions Appear Modest When Compared With Comparable Matters

As sanctions, the board imposed censure and a two-year limitation on Koepfel's activities and no civil money penalty. Given the serious audit deficiencies over multiple audit years, the sanctions appear to be on the lower end

of the spectrum. For example, the board recently issued a settled order involving another GT engagement partner, David M. Burns, who was charged with similar violations involving failing to properly supervise the engagement team, filing to exercise due professional care, and failing to obtain sufficient appropriate audit evidence for a single audit of The Bancorp Inc.^[23] Burns was censured, barred for a year, restricted for an additional two years if he ever is permitted to associate with a registered firm, and fined \$15,000.

Similarly, an engagement partner at the largest accounting firm in Salt Lake City was sanctioned for failing to exercise due professional care and obtain sufficient appropriate audit evidence despite knowledge of red flags and contradictory audit evidence in connection with the audit of a public company's financial statement for two years.^[24] Like Burns, Kent M. Bowman, was censured, barred for a year, restricted for an additional two years if he is ever permitted to associate with a registered firm, and fined \$25,000.

Moreover, in a 2015 settled order, the SEC sanctioned Koepfel for similar audit violations for two audit clients over multiple years imposing a five-year bar from practicing before the SEC and \$10,000 civil money penalty. On the surface, the Koepfel order sends an implied, and likely unintended, message that a respondent may be able to obtain lesser sanctions by litigating than settling.

Litigation Process Allows a Respondent to Delay Public Disclosure

It is a known fact that the confidentiality of PCAOB investigations and disciplinary proceedings creates an incentive for respondents to litigate rather than settle proceedings if they are concerned about public disclosure. The Koepfel decision highlights this fact.

Koss disclosed the fraud in late 2009 and filed a Form 10-K/A in June 2010. The decision states that on Aug. 16, 2011, following an investigation, the board issued an order instituting disciplinary proceedings, or OIP.^[25] The nine-day hearing occurred in June and October 2012, and the hearing officer issued the initial decision on Jan. 29, 2013.^[26] Litigating before the hearing officer took almost a year and a half.

The appeal to the board took almost three times as long. Briefing for the appeal was completed on June 7, 2013, and oral argument occurred on October 22, 2013.^[27] It took the board over four years to issue its decision after oral argument.

Notes

- [1] *In the Matter of Melissa K. Koepfel, CPA, PCAOB File No. 105-2011-007 (Dec. 29, 2017).*
- [2] *The “Ken Lay,” “aw, shucks,” or “ostrich” defense is a defense put forth in many high-profile accounting fraud trials in the early to mid-2000’s by former Enron CEO Ken Lay, former Worldcom CEO Bernard Ebbers, former CUC CEO Walter Forbes, and others that they delegated responsibilities to competent subordinates and were unaware of subordinates’ misdeeds.*
- [3] *Id.* at 81-82.
- [4] *Prior to GT, Koepfel worked at Arthur Andersen from 1986 until its Enron-related demise in 2002.*
- [5] *Koepfel, at 9-10*
- [6] *Id.*
- [7] *Id.*
- [8] *Id.* at 1.
- [9] *Id.*
- [10] *Id.*
- [11] *AU Section 311 was superseded in 2010 by two separate standards for planning and supervision, Auditing Standard No. 9, Audit Planning (AS 2101) and Auditing Standard No. 10, Supervision of the Audit Engagement (AS 1201). See Auditing Standards Related to the Auditor’s Assessment of and Response to Risk and Related Amendments to PCAOB Standards, PCAOB Rel. No. 2010-004 (Aug. 5, 2010).*
- [12] *Koepfel, PCAOB File No. 105-2011-007, at 78.*
- [13] *Id.* at 78-79.
- [14] *The board relied extensively on the SEC’s characterization of the role of the engagement partner in Dearlove that vests the engagement partner with responsibility for the use of audit assistants and with a continuing responsibility as the auditor with final responsibility for the audit. See Gregory M. Dearlove, CPA, SEC Rel. No. 2779, 2008 WL 281105 (Jan. 31, 2008).*
- [15] *Id.* at 79.
- [16] *Id.*
- [17] *Id.* at 81.
- [18] *Id.*
- [19] *In the Matter of Grant Thornton LLP, SEC Rel. No. 34-76536 (Dec. 2, 2015); In the Matter of Melissa K. Koepfel, CPA, and Jeffrey J. Robinson, CPA, SEC Rel. No. 34-76537 (Dec. 2, 2015).*
- [20] *Interestingly, the order against Koepfel and Robinson noted that Koepfel had been removed from all but one public audit engagement by the fall of 2010. GT also placed Koepfel on a November 2010 monitoring list for partners with negative quality indicators, because, in part, her audit clients had restated their financial statements or interim financial information four times in the preceding two years. Koss was one of the restatements that led to Koepfel’s inclusion on the partner monitoring list.*
- [21] *Koepfel, at 81.*
- [22] *Id.* at 78.
- [23] *In the Matter of David M. Burns, CPA, PCAOB Rel. No. 105-2017-055 (Dec. 19, 2017).*
- [24] *In the Matter of Kent M. Bowman, CPA, PCAOB Rel. No. 105-2017-030 (July 25, 2017).*
- [25] *Koepfel, at 2.*
- [26] *Id.*
- [27] *Id.*

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