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Individual Decisions and Public Trust: The PCAOB and KPMG

Katherine Campbell and Duane Helleloid
University of North Dakota, USA

Abstract. What might seem like a small ethical transgression by an individual can lead to a series of subsequent decisions, and result in serious fraud. This can not only impact the individuals involved and their organizations, but also erode public trust in firms and institutions. When Brian Sweet left a position with the Public Company Accounting Oversight Board (PCAOB), an organization that oversees the inspection of audits, and went to work for KPMG, one of the large accounting firms whose audits he had inspected, he took with him confidential information that he thought could prove useful in his new position. Sweet subsequently shared confidential information with his new employer, and over the next two years acquired additional confidential information through contacts at PCAOB. Debra Kaufmann, a KPMG audit partner, was faced with a decision about how to react when Sweet shared confidential information that she believed neither she nor KPMG should have.

Keywords: fraud, confidential information, subordination of judgment, codes of conduct.

1. Introduction

On February 3, 2017 Debra Kaufmann[1] had just gotten off a phone call with Brian Sweet. Kaufmann, an audit partner in KPMG's Chicago office, worked with several of the public accounting firm's banking clients. Sweet, a partner in KPMG's national office, was involved in efforts to improve the firm's overall audit quality. More specifically, he was involved with several initiatives designed to improve the firm's performance on audit inspections performed by the Public Company Accounting Oversight Board (PCAOB). Sweet had joined KPMG two years earlier, after working for the PCAOB as an inspector on some of the board's inspections of KPMG audits. Sweet told Kaufmann that the audit underway at one of her banking clients, Chemical Financial, would be inspected by the PCAOB in the coming year. Kaufmann was surprised that Sweet seemed certain that the PCAOB had already decided that this particular audit would be inspected, something that perhaps only a few people inside the PCAOB should have known

1. Debra Kaufmann is a pseudonym for an individual identified in U.S.A v. Middendorf, Whittle, Britt, Holder, and Wada (2018) as "Partner #5". No other names are disguised.

while the audit was ongoing. The only way that Sweet could know with certainty that this specific audit would be inspected was if he had access to confidential PCAOB information that neither he nor KPMG should know. At the end of call, Kaufmann thanked him for the information, but she now had to consider what she should do about her suspicions that Sweet, and now she, may improperly have confidential PCAOB information. (U.S.A. v. Middendorf and Wada 2019)

2. The PCAOB

The Public Company Accounting Oversight Board (PCAOB) was established in 2002 in the wake of a series of high-profile accounting scandals and audit failures including those involving Worldcom and Enron. Through the Sarbanes-Oxley Act, the PCAOB was charged with setting auditing standards, performing inspections of audits, and protecting "the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports" (SEC, 2018b). This legislation ended the accounting profession's self-regulation, and for the first time in history, auditors of U.S. publicly traded companies were subject to the oversight of independent regulators. The PCAOB was created as a private, non-profit organization overseen by the U.S Government's Securities and Exchange Commission (SEC) (PCAOB 2019a).

Among other activities, the PCAOB annually inspected a portion of the audits of those firms that performed over 100 audits a year, and it inspected audits of smaller audit firms every three years. The "Big Four" public accounting firms (Deloitte, KPMG, PwC, and EY) performed financial statement audits of companies that comprised about 98% of global market capitalization, bringing their practices under particular scrutiny (Dickins, *et. al.* 2018). In recent years the PCAOB had chosen to focus its inspection activities on audits that were considered complex, high risk, and/or where past experience suggested that there was a higher probability of deficiency in the audits (Dickins, *et. al.* 2018; Michaels and Rapoport 2017). Some inspections, however, were selected at random.

The goal of the PCAOB was not to "catch" bad auditors or levy fines (it did not have that authority), but to improve overall audit quality and increase investor confidence in the quality of audited financial reports. Each year the PCAOB selected approximately 50 of the audits performed by each of the big four public accounting firms, and carefully reviewed the approach and thoroughness of the audits. The PCAOB then compiled the results of their inspections for each public accounting firm, and published a report on its website (https://pcaobus.org/Inspections/Reports/Pages/default.aspx). If PCAOB inspectors determined that an audit was not conducted with sufficient scrutiny and thoroughness to justify the audit opinion, it deemed the audit deficient and provided an explanation. A finding of deficiency did not necessarily mean that the underlying financial reports were inaccurate (PCAOB 2022). Rather, a finding of deficiency meant that the auditor "had not obtained sufficient appropriate evidence to support its [audit] opinion" (PCAOB 2019b).

PCAOB inspections were critical to fulfilling the organization's mission of protecting investors and furthering the public interest. Professional integrity among PCAOB employees responsible for strictly maintaining the confidentiality of its inspection targets, and the methodology used to select them, was an important means of ensuring the integrity of the PCAOB's inspection process and fulfilling its obligations to the public (SEC 2018b).

3. KPMG

KPMG was one of the big four accounting firms, and operated a worldwide network of affiliated offices in over 150 countries. In its 2017 Annual Report, KPMG reported revenues of over $26 billion, while employing almost 200,000 people. Auditing services were KPMG's largest source of revenue, followed by advisory and tax services (KPMG 2017).

As a result of its size, KPMG was subject to annual inspection by the PCAOB. Table I reports the number of KPMG audits inspected and those determined to be deficient by the PCAOB.

Table 1: PCAOB Inspections of KPMG Audits

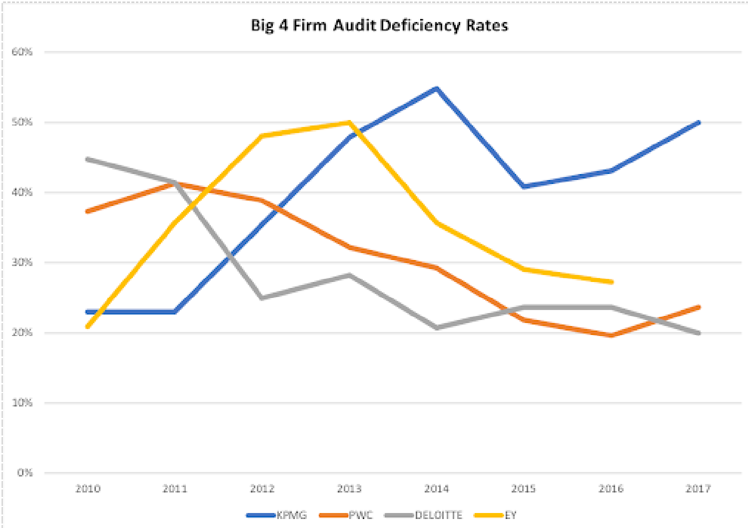
Year*	Total Number of Inspections	Deficiencies (Percentage)
2017	52	26 (50%)
2016	51	22 (43%)
2015	49	20 (41%)
2014	51	28 (55%)
2013	48	23 (48%)
2012	48	17 (35%)
2011	52	12 (23%)
2010	52	12 (23%)

*The 2012 inspection year refers to inspections that took place from October 2011 through February 2013. The audits inspected were generally for a company's fiscal year end 2011 financial statements. The PCAOB "2012 Inspection Report for KPMG" was issued in July 2013. The "Year" generally refers to the time when the PCAOB performed the inspections.
Source: PCAOB Website (2010 – 2017 KPMG Inspection Reports) https://pcaobus.org/Inspections/Reports/Pages/default.aspx

KPMG's PCAOB audit inspection deficiency rate was much lower in earlier than in later years, and in 2011 its deficiency rate was lower than that of the other big four firms. (See Figure 1 for deficiency rates of all four firms from 2010 –

2017.) The increasing deficiency rate raised concerns both at KPMG and the PCAOB.

Figure 1



Source: PCAOB Website (https://pcaobus.org/Inspections/Reports/Pages/default.aspx)

4. KPMG Response to Deteriorating PCAOB Inspection Results

In September 2014, the PCAOB reported a substantial increase in KPMG's audit deficiency rate from the previous year (SEC 2018b). This public indicator of declining audit quality at KPMG heighted attention from the firm's leadership and internal pressure to improve; one response was prioritizing the recruitment of Brian Sweet, an Associate Director at the PCAOB who worked on the inspection of KPMG audits (SEC 2018b). In May 2015, KPMG hired Sweet in a position as a partner in the firm's Office of Professional Practice (OPP), which was responsible for maintaining audit quality and improving audit practices. One of Sweet's responsibilities at KPMG was conducting internal inspections of the firm's audits (SEC 2018b).

Sweet, along with three high-level KPMG partners were involved in developing and implementing a process to improve their firm's PCAOB deficiency rate by improperly using confidential PCAOB information. These partners were David Middendorf, National Managing Partner for Audit Quality and Professional Practice; Thomas Whittle, KPMG's National Partner-In-Charge for Inspections; and David Britt, KPMG's Banking and Capital Markets Group Co-Leader (SEC 2018b). The approach relied in part on securing, in advance, confidential PCAOB information regarding which KPMG audits would be inspected and the focus of each inspection. The firm could then pay particular attention to the thoroughness of these audits in order to decrease the likelihood of