PREMIUM ACCOUNTING

Accountants in the hot seat

By Antoinette Alexander March 04, 2024, 10:00 a.m. EST 11 Min Read


THE LEASE ACCOUNTING REVOLUTION P.19 | FAST-TRACKING YOUR CIO P.28
accountingTODAY
accountingtoday.com | Vol. 38 | No. 3 | March 2024
1040
AUDIT REPORT
In the hot seat
The regulatory environment around accounting, audit and tax is getting stricter

interrogation room.

An increasingly complex regulatory environment and advancements in technology are no doubt fueling changes throughout the accounting profession, and regulators are not turning a blind eye. Enforcement activities by the Public Company Accounting Oversight Board, the U.S. Securities and Exchange Commission, the Internal Revenue Service, and others have increased in an effort to target audit deficiencies, boost tax compliance, and drive greater accountability.

In fact, reports released in 2023 by consulting firm Cornerstone Research highlighted the sharp uptick in enforcement actions by both the PCAOB and the SEC.

According to Cornerstone's "PCAOB Enforcement Activity—2022 Year in Review" report, enforcement activity rose sharply in 2022, accompanied by record-setting penalties. More specifically, the report states that, in 2022, the PCAOB publicly disclosed 29 disciplinary actions involving the performance of an audit or a firm's system of quality controls. That was up more than 60% compared with 2021, and was also higher than the 2017-21 average (24 PCAOB actions).

Furthermore, monetary penalties totaled nearly $10.5 million, the largest amount in the board's history up to that date, and a nearly tenfold increase compared with 2021. (It would go on to beat that record handily in 2023, hitting $11.9 million by mid-November, but final numbers for the year are not yet available.)

"The record penalties were consistent with statements made by chair Erica Williams that the PCAOB would not be limited to the levels of penalties in past years," said Elaine Harwood, a report co-author, and senior vice president, and head of the accounting practice at Cornerstone Research, in a statement announcing the findings. "Penalties totaling $7.9 million were imposed on the 10 actions disclosed in December [2022] alone."

Separately, Cornerstone Research revealed a spike in SEC enforcements in its "SEC Accounting and Auditing Enforcement Activity — Year in Review: FY 2022." According to the report, the commission publicly disclosed 68 accounting and auditing enforcement actions in fiscal year 2022, up 55% compared with the prior fiscal year; they made up 15% of the 462 new or "stand-alone" actions initiated in 2022.

The trend shows no signs of slowing as regulators are likely to further tighten the screws in an already complex environment.

The PCAOB ramps up enforcement

statements.

In remarks delivered in November at the 2023 PCAOB International Institute on Audit Regulation, for instance, chair Erica Williams indicated that, "Now is the time for solutions, not excuses. Firms must correct the problems that led to deficiencies in their audits."

She added, "When inspection reports are finalized later this year, PCAOB inspectors expect that approximately 40% of the audits they reviewed in 2022 will have had one or more deficiencies where the audit firm failed to obtain sufficient appropriate evidence to support its opinion. That is up six percentage points from 2021, which was already five points higher than the deficiency rate in 2020. This means audit opinions were signed without completing the audit work required to verify the accuracy of the financial statements. That is a serious problem at any rate, and 40% is completely unacceptable."

Continued Williams, "We are continuing our work to hold bad actors accountable through strong enforcement. We are making sanctions count. We are expanding how we identify cases. And we are expanding the types of cases we are pursuing."

(See more on the PCAOB's recent [flood of fines, penalties and worse.](#))

And in a statement sent to Accounting Today on the board's stricter enforcement efforts, a spokesperson said, "Our mission at the PCAOB is to protect people who invest in public companies. One way we do that is through enforcement actions when our rules or standards are violated. We carefully monitor registered accounting firms and will not hesitate to take action when appropriate."

In step with its efforts, the overseer has issued a proposal to amend PCAOB Rule 3502, "Responsibility Not to Knowingly or Recklessly Contribute to Violations."

Originally enacted in 2005, the current Rule 3502 holds auditors liable for firms' violations when they "recklessly" contribute to those violations. If adopted, the proposal would lower Rule 3502's liability standard from recklessness to negligence and would arm the PCAOB with the tools it believes it needs to hold auditors more accountable.

The proposal goes a step further and, as explained by the board, "clarifies that associated persons of any firm can be held liable as long as their conduct at least negligently, and directly and substantially, contributes to any firm's violation, not just violations by a firm with which they are associated."

While high-quality audits are undoubtedly critical, the board's proposal to strengthen the liability standard has raised the eyebrows of some industry professionals and sparked concern over the potential implications.

The PCAOB has encouraged public comment on the proposal and many within the profession have been quick to respond, including PwC, Moss Adams and Grant Thornton, to name a few.

In a written response, Big Four firm PwC expressed concerns and stated that the "proposal could shift the liability landscape in ways that will undermine the objectives of the proposal and adversely affect the quality of public company audits."

A separate comment submitted by Seattle-based Top 25 Firm Moss Adams noted, "We are concerned that the proposal could exacerbate the accounting talent crisis. We believe there is a risk of inefficient and unproductive 'self-protective' behavior that will occur if the amendments are approved. Further, the proposal could have a negative impact on smaller firms and reduce the market for audit services."

Chicago-based firm Top 10 Firm Grant Thornton also voiced its apprehensions and wrote in a comment letter, "The perceived gap in the PCAOB's current regulatory framework appears minimal at best. It does not appear to be the type of gap that warrants a stark expansion of the enforcement-related tools that the board currently possesses."

While the profession has expressed support of the PCAOB's underlying mission to protect investors and promote audit quality, there are calls for more finesse.

"It is important that there's a balanced approach to enforcement and that the PCAOB is focused on those actions that truly harm investors or are clear, significant violations of the board's rules and standards. And certainly when those actions occur and there's harm to investors and it is clear what happened, certainly enforcement actions are important, but that should be balanced with: Are there underlying reasons for those violations that has maybe more to do with a lack of understanding and how to apply those requirements? If they think that it could be addressed through clarification and standards and rules to help prevent those violations from occurring, I think that is an important way to stop these things from happening before they even happen," said Dennis McGowan, vice president of accountingTODAY

As noted earlier, the momentum shows no signs of slowing. Pointing to the PCAOB's multipronged 2022-26 strategic plan, McGowan said, "I think paying attention to what is happening on the standard-setting front, the inspections front, and the enforcement front are all relevant for anyone who is an auditor in the profession right now."

The IRS tightens the screws

Meanwhile, in the tax arena, the IRS is expanding its enforcement efforts, which include, among many things, a crackdown on "unscrupulous" tax preparers.

Following the agency's budget increase of roughly $79 million under a provision of the Inflation Reduction Act, its renewed focus on tax law enforcement quickly became more evident.

In a Sept. 18, 2023, letter to members of Congress, IRS Commissioner Danny Werfel wrote, "Following a top-to-bottom review of enforcement and in line with our Strategic Operating Plan, IRS has begun announcing sweeping efforts to overhaul compliance efforts to improve tax administration."

"We are devoting more resources to addressing unscrupulous preparers who are leading their customers to underreport income or overclaim credits and deductions. To do so, we are leveraging data that identifies tax preparers with questionable practices," Werfel wrote. "Our research suggests that these bad actors disproportionately file tax returns for vulnerable taxpayers, including low-income filers, filers of color, and those with limited English proficiency, which may contribute to higher audit rates for this taxpayer segment."

This move is just one part of the broader initiatives underway at the IRS. Key elements of its renewed efforts include:

- Increased pursuit of high-income, high-wealth individuals who have either not filed their taxes or failed to pay recognized tax debt.
- Leveraging artificial intelligence to ramp up audits of 76 of the largest partnerships in the U.S. that represent a cross-section of industries.
- Increased pursuit of multimillion-dollar partnership balance sheet discrepancies.

Meanwhile, enforcement actions handed down by various state tax agencies and other regulators continue to make headlines as well.

"There are a couple of impulses among tax legislators on Capitol Hill: to blame the professionals when something bad happens, [and] to increase reporting. Frequently, when they don't know what to do about something, they just make people report it more and let the IRS deal with it," explained Chris Rizek, a member in the Washington, D.C., office of law firm Caplin & Drysdale.

"The penalty provisions, I think, are a little bit over the top. The policy behind creating penalty provisions, I could talk about for a long time, but they have to be dialed in right. I mean, you don't send someone to the chair for a parking ticket and you don't let an ax murderer pay a $25 fine and skate," he explained. "You have to dial in the right amount of penalty … and I think Congress, to put it gently, I would just say they have struggled with that. I think the penalties have not been as strong in some areas as they should be, but have been over the top in other areas. And that — particularly the latter course — empowers the IRS to kind of beat up on people. But I think there's a

The question now facing many firms, even those that do not provide regulated services, is what does it mean for their practice, and is there a need for greater internal controls?

Take action

Over the next few years, industry sources expect the changes and new developments in regulation to continue. Taking the necessary steps now to proactively reduce risk — such as ensuring strong quality control measures are in place, staying informed of industry developments, leveraging technology, and upskilling staff — is essential for firms.

Said Carl Mayes, vice president of audit and accounting quality at the American Institute of CPAs and the Chartered Institute of Management Accountants, "It's important for firms to double down on their strengths. Developing core expertise in specific areas is essential to providing quality service. Deemphasizing or exiting nonstrategic lines of business can also help enhance overall quality and compliance. Businesses are embracing new ways of working and reassessing how they measure value. To meet these evolving needs, accountants must continue to embrace a culture of continuous learning."

Mayes noted that advancements in technology are fueling the need for greater assurance of systems and data. While innovative technology can present some challenges, such as the increased use of generative AI in business, for instance, it also unlocks greater efficiency and more data-driven, strategic insights."

"Automation and artificial intelligence are making compliance more manageable. Technology that modernizes the audit and assurance process, such as the Dynamic Audit Solution and OnPoint products, are examples of powerful tools that have the potential to enhance productivity," Mayes said.

"We know growing complexity in business — and the opportunities and challenges it brings — is a key driver in the evolution of the accounting profession," he added. "Technology and innovation can help improve efficiency and access to critical information. … We also have seen firms themselves recently commit to investments in audit quality (including technology) to improve their performance. Another rising trend is upskilling in new service lines such as sustainability, cyber risk and data governance."

Rizek also stressed the importance of continuous learning, especially in today's complex tax environment, and urged firms to bolster their compliance regime, if they haven't already done so.

"Every firm should have a couple of things for their compliance regime. They need to have someone who is very well-versed in these subjects, a general counsel or someone in their risk management function who is familiar with the sources of law and the standards applicable to transaction structuring, tax advice, opinions, return preparation, representations during examinations, something as simple as the power-of-attorney rules. Somebody needs to know that, and every lawyer or accountant who does tax, at least, should have somebody in their firm that they can go to and ask questions about that. That's the first thing," said Rizek. "Secondly, everybody needs to educate themselves about it." AT

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