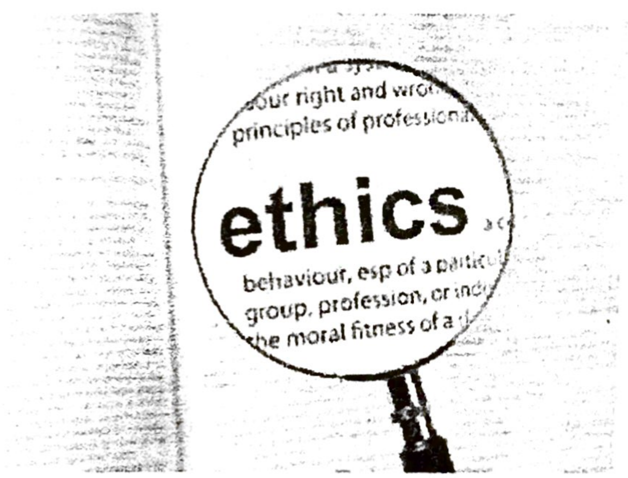
Opinion: KPMG Insider Trading Scandal Damages the Reputation of the Accounting Profession

Posted by de-admin • May 6, 2013 • Printer-friendly

by Steven Mintz

What possesses an audit partner to trade on inside information and violate the accounting profession's most sacred ethical standard of audit independence? Is it carelessness, greed, or ethical blindness? In **the case of Scott London**, the former partner in charge of the KPMG's Southern California's regional audit practice, it was a bit of each that motivated him to violate ethical standards and, in the course of doing so, causing the audit opinions signed by London on **Skechers** and **Herbalife** to be withdrawn by the accounting firm.



Overall, London is charged with leaking confidential information to his friend, Brian Shaw, about Deckers, Pacific Capital Bancorp, Manhattan Beach-based Skechers, and Los Angeles-based Herbalife. The leak of information about quarterly earnings information led to Shaw's unjust enrichment of $1.27 million. Shaw, a jewelry store owner and country club friend of London, repaid London with $50,000 in cash and a Rolex watch, according to legal filings.

The leaking of financial information about a company to anyone prior to its public release affects the level playing field that should exist with respect to personal and business contacts of an auditor and the general public. It violates the fairness doctrine in treating equals, equally, and it violates basic integrity standards. London and Shaw acted in a way that cuts to the core values of integrity and trust – the real foundations of our free enterprise system.

The KPMG scandal concerns me because a pattern of such improprieties may be developing. In 2010, Deloitte and Touche was **investigated by the SEC for repeated insider trading** by Thomas P. Flanagan, a former management advisory partner and a Vice Chairman at Deloitte. Flanagan traded in the securities of multiple Deloitte clients on the basis of inside information that he learned through his duties at the firm. The inside information concerned market moving events such as earnings results, revisions to earnings guidance, sales figures and cost cutting, and an acquisition. Flanagan's illegal trading resulted in profits of more than $430,000. In the SEC action, Flanagan was sentenced to 21 months in prison after he pleaded guilty to securities fraud. Flanagan also tipped his son, Patrick, to certain of this material non-public information. Patrick then traded based on that information. His illegal trading resulted in profits of more than $57,000.

The KPMG case is a particularly egregious one because it involves insider trading by an auditor of client stock. This incident jogged my memory and I came up with a characterization of London's actions as "stupid is as stupid does." *Forrest Gump* quotes are uncomplicated, basic and true. They are almost Zen-like in their simplicity. This one fits Scott London's actions perfectly. However, in public accounting stupidity is not a defense for violating the independence standard that protects the public from shortsightedness and egoistic behavior on the part of auditors who are charged to protect the public interest.

This isn't the first time in recent years that KPMG has been investigated for gross violations of ethical standards. In 2005, KPMG agreed to pay a hefty fine of $456 million and cease its private client tax practice after admitting that it defrauded the government and the IRS in a major tax shelter scandal. The firm agreed not to develop, sell, or implement any pre-packaged tax products. Three staff members were sentenced to serve terms ranging from 6 ½ to ten years in prison as a result of providing **opinion letters that endorsed the shelters** and helped KPMG's wealthiest clients claim bogus losses to offset their massive capital gains.

In withdrawing its audit opinion on Skechers and Herbalife, KPMG released a statement that should raise red flags for all CPA firms that audit public companies. The firm stated it had concluded it was *not independent* because of alleged *insider trading.* This is a weak statement at best and illustrates the moral blindness of some public accounting firms that do not seem to realize they are at fault for the actions of auditors with respect to the use of inside information.

Public accounting firms have an ethical obligation to monitor the actions of its partners, managers, and staff that may impair audit independence. The failure in this instance of KPMG is in its lack of quality controls to prevent and detect violations of basic ethical standards. I call on the California Board of Accountancy to investigate the KPMG insider information case for the firm's failure to properly oversee its own internal controls on safeguarding client information and monitoring the independence standards that underlie audited financial statements and build trust in our financial reporting system.

7 May 2016

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Brief Summary of the article

This article addresses accounting auditors and their access to private information when auditing public firm. The auditor has the ability to use or not to use the information discovered during the audit to gain an unfair advantage by trading based on this information which will cause he or she receive monetary gain. Scott London was a partner at KPMG until he violated ethical standards by leaked financial information prior to the release to the public. One could conclude that this one incident was an unlikely incident in the accounting industry however it seems like this pattern of improprieties may be developing throughout the industry.

Ethical issue/dilemma

The ethical dilemma in this article is the accounting professional ability to have access to their clients information and using this information for the audit only and not their personal gain.

Impact on business operations

The impact on business operations is that businesses now understands they have an ethical obligation to monitor the actions of its partners, managers and staff which may impair audit independence. The firm must also monitor their "internal controls on safeguarding client information and monitoring the independence standards that underlie audited financial statements and build trust in their financial system." As a result of the incident at KPMG business are more susceptible to receiving fines. The auditor leave themselves open to jail time if they act illegally.