

KPMG AND THE U.S. DEPARTMENT OF JUSTICE: A CASE OF COERCION?

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Abstract

On August 25, 2005 KPMG signed a deferred prosecution agreement with the US Department of Justice (DOJ). KPMG, while under investigation, audited the DOJ. The 28-page agreement allowed KPMG to continue its audit of the DOJ, pay \$456 million in fines, and contained other provisions. Due to the agreement KPMG as able to remain in business thereby prevented the collapse of the firm. In addition, KPMG was allowed to complete its audit of the DOJ. However, was KPMG coerced to sign the agreement for fear of the same fate as Arthur Andersen? This paper discusses the agreement, independence, and the subsequent criminal case against former KPMG employees by the DOJ.

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INTRODUCTION

What type of public policy permits an accounting firm (KPMG) to audit the prosecutorial body (US Department of

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Justice) investigating an alleged major criminal offense it may have committed? The allegation against KPMG was not minor. In fact, the Internal Revenue Service (IRS) claims that the case against KPMG is the largest criminal case ever. Nevertheless, KPMG audited the US Department of Justice (DOJ) at the same time it was being investigated and entered into a deferred prosecution agreement. This presents several serious questions about the accounting profession and the policy of the DOJ. Due to the size of the audit and the seriousness of the allegation, was the investigation and related litigation fair? Alternatively, were the results of the audit accurate or perhaps was KPMG coerced in order to obtain a favorable criminal outcome? What safeguards does our society have to protect the potential abuse of power by the DOJ against auditors, such as KPMG? Does the accounting profession permit this type of relationship between an adversarial client and an auditing firm? How does a firm survive the threat of extinction by the DOJ? Arthur Andersen did not survive and was dismantled by a single felony conviction, even though the firm prevailed on appeal. Arthur Andersen, before its demise, was viewed by many as the premier and largest accounting firm in the world.

On August 25, 2005 KPMG signed a deferred prosecution agreement with the DOJ. KPMG, while under investigation, audited the DOJ. The 28-page agreement allowed KPMG to continue its audit of the DOJ, pay \$456 million in fines, and contained other provisions. This agreement allowed KPMG to remain in business and removed the risk of the firm collapsing. However, was KPMG coerced to sign the agreement for fear of the same fate as Arthur Andersen? What possible safeguards could KPMG have in place to mitigate the threat of extinction by the DOJ while concurrently performing an audit of the DOJ?

CPA's before accepting an auditing engagement must submit to a variety of tests of independence and then maintain a high level of integrity throughout the audit. Unlike the tax professional they must remain independent. They make disclosures

about their professional and personal matters (e.g. investments) to comply with laws, regulations, and standards.

Professionals, such as accountants and lawyers, render opinions regarding matters and may inadvertently violate applicable standards of independence and/or integrity. In addition, some push the envelope to achieve a favorable outcome for their client. If these professionals violate our laws or codes of conduct, they are subject to prosecution or administrative sanctions.

Integrity is the hallmark of the accounting profession and must be maintained. Independence is paramount to a reliable audit. Sadly, both integrity and independence are sometimes breached (intentionally or inadvertently) by members of the accounting profession. Justifiably, integrity and independence standards for CPA's are high.

However, what if the nation's central agency for enforcement of federal laws is overzealous in pursuit of a "win"? Moreover, consider, if that agency coerced an accounting firm, under criminal or civil investigation, to issue "favorable" audit opinions pertaining to itself.

Background

According to its website (www.kpmg.com) KPMG is a worldwide organization operating in 148 countries with over 113,000 people within member firms providing audit, tax, and advisory services. It is one of the largest accounting firms in the world. The DOJ is one of its clients: KPMG audits the DOJ. On its website (www.Doj.gov), the DOJ presents itself as, "the world's largest law office and the central agency for enforcement of federal laws." Accordingly, the DOJ is responsible for prosecuting federal crimes. It employs over 100,000 people worldwide and is comprised of dozens of powerful agencies, including the U.S. Attorneys Office (USAO) and the Federal Bureau of Investigation.

It is not difficult to recall the many financial scandals reported in the United States over the last 10 years. Some of these scandals include Enron, WorldCom, Adelphia Communications,

and Tyco. The scandal at Enron resulted in the demise of Arthur Andersen, which at the time, was the largest accounting firm in the country. Criminal prosecutions also occurred in many of the above cases.

Congress reacted to the scandals and passed the Sarbanes Oxley Act of 2002 (SOX). President Bush also responded by issuing an executive order (13721) dated July 9, 2002, which established a Corporate Fraud Task Force within the DOJ.

In June 2002 the DOJ obtained a conviction against Arthur Andersen for obstruction of justice. This conviction led to the revocation of their audit licenses and eventual dismantling. However, in May 2005, the US Supreme Court reversed that conviction. The reversal was a setback for the DOJ. How could it explain the firm's demise and the loss of thousands of jobs without a conviction? Perhaps the solution is to criminally prosecute and fine the next entity pursued but also make sure that it stays in business. KPMG may have provided the perfect opportunity for the DOJ to position itself as fighting corporate fraud.

In or around 2002 the IRS, while investigating tax shelters, directed its efforts towards KPMG. On August 26, 2005, the DOJ and KPMG entered into a deferred prosecution agreement, wherein KPMG accepted responsibility for actions related to former partners and employees. Those actions included preparing fraudulent tax returns, false statements, concealing tax shelters (and the facts regarding them) from the IRS, and other related actions from 1996 until 2002. Several employees were indicted but the charges were later dismissed because the government (DOJ) violated the defendant's constitutional rights and held a "proverbial gun" to KPMG's head (US v Stein, p.2).

The United States Department of Justice (DOJ)

According to its website, the DOJ officially began on July 1, 1870 ("the 1870 Act"), with the responsibility to handle the legal business of the United States. The 1870 Act gave the DOJ control over all criminal prosecutions and civil suits in which the

United States had an interest. Moreover, it gave the Attorney General and the Department control over federal law enforcement. The 1870 Act continues as the foundation upon which the DOJ operates. Furthermore, its mission is “to enforce the law and defend the interests of the United States according to the law; to ensure public safety against threats foreign and domestic; to provide federal leadership in preventing and controlling crime; to seek just punishment for those guilty of unlawful behavior; and to ensure fair and impartial administration of justice for all Americans” <http://www.Doj.gov/02organizations/>.

When Mr. Gonzales became Attorney General in February 2005, it marked the “beginning of a tenure that by its end was anything but quiet, as scandals over the firing of prosecutors and improper involvement of partisan motives in the Justice Department's workings multiplied over the course of 2007,” (NY Times, 8/27/2007). Mr. Gonzales resigned September 17, 2007.

http://topics.nytimes.com/top/reference/timestopics/people/g/alberto_r_gonzales/index.html “(Alberto R. Gonzales).

The DOJ, especially since 9/11, was marred by scandals. Arguably, it did not want any more. In particular, did the DOJ want to put another large accounting firm out of business? On the contrary, maybe there is a method to prosecute, fine, and make sure that the company stays in business. However, the DOJ would need to be creative.

Deferred Prosecution Agreement (DPA)

In an effort to survive, KPMG entered into a 28-page deferred prosecution agreement (DPA) dated August 26, 2005. KPMG consented to the filing of a one count indictment in a conspiracy to defraud the United States, commit tax evasion, make and subscribe false and fraudulent tax returns, and assist in the preparation and filing of said tax returns. The agreement required KPMG to pay \$456 million in fines, restitution and penalties. Other terms and conditions included the following:

That KPMG will not deduct the \$456 million on any Federal or State tax or information return

That no portion of the fine will be covered by insurance

Admission of assisting high net worth citizens to evade individual income taxes on billions of dollars in capital gains and ordinary income by developing, promoting and implementing unregistered and fraudulent tax shelters

Permanent restrictions on KPMG's tax practice

KPMG will comply with the ethics and independence rules as adopted by the Public Company Accounting Oversight Board

KPMG will cooperate with the ongoing criminal investigation

The DOJ deferred the prosecution until December 31, 2006. If KPMG complies with the provisions of the DPA, the DOJ will seek dismissal of the indictment

KPMG agreed to an independent monitor

The DOJ's debarring official determined that KPMG will not be barred from continuing its audit engagement of the DOJ

KPMG emerged from the DPA by complying with the provisions of the agreement. Texas, California, South Carolina, and other State Public Accounting regulatory bodies fined the firm.

In Texas, the State Board of Public Accountancy imposed penalties for 96 violations of the Public Accountancy Act at \$1,000 per violation. Their license was suspended for 5 years, but the suspension was stayed and the firm was placed on probation for 3 years. Also, KPMG was required to pay \$3,842.45 in administrative costs.

California suspended KPMG's license but stayed the decision. In addition, KPMG was fined \$1,000,000, reimburse the board for investigative costs, and meet other terms and conditions.

South Carolina ordered KPMG to pay \$10,000 with other conditions. Interestingly, item 2 of the consent agreement states the following:

Respondent (KPMG) "has been notified and understands that the spouse of counsel for the Agency" (South Carolina

Department of Labor, Licensing and Regulation) ...” has a pending matter with a client ...which involves a dispute between ... and KPMG. Respondent agrees to waive any and all objections to participation by counsel for the Agency in the above-referenced matter and agrees not to appeal any decision of the Agency on the basis of this issue” (P.3).

Notwithstanding the investigation, probation, monitoring, and other consequences, KPMG retained DOJ as its client. Moreover, KPMG issued an Independent Auditors’ reports on DOJ’s internal controls and financial statements. KPMG was the audit firm before and after the DPA.

The IRS website reported that the KPMG case is the largest criminal case ever filed. What the site does not report is that no court determined the fraudulent actions (alleged by the IRS) were in fact true.

In an open document, the National Association of Criminal Defense Lawyers (NACDL) wrote that the intended message from the government concerning Arthur Andersen’s demise and KPMG’s survival is clear: “KPMG cooperated, Arthur Andersen did not.” In addition, the association wrote, “it appears that even the suggestion by the government that it is looking into potential wrongdoing is sufficient for the business to feel compelled to sacrifice assertions of rights or defenses and to allow the rights and livelihoods of their employees to fall by the wayside.” (<http://www.nacdl.org/public.nsf/printerfriendly/A0511p44?openDocument>) Some may argue the DPA is no different than a defendant confessing to a crime after the police threaten or coerce a suspect.

Independence

As CPA’s KPMG must adhere to independence standards of the American Institute of Certified Public Accountants (AICPA). Section 100.01 AICPA’s code of ethics articulates the framework for independence standards. It describes the risk-based approach to analyzing independence matters that is used to develop

these standards by the professional ethics committee of the AICPA. The risk-based approach involves identifying threats to independence and determining if safeguards eliminate or sufficiently mitigate threats to independence. If the threats are not eliminated or sufficiently mitigated (to an acceptable level) independence is considered impaired. Within this framework, independence is defined (100.06) as:

a. Independence of mind - The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

b. Independence in appearance - The avoidance of circumstances that would cause a reasonable and informed third party, (having knowledge of all relevant information, including safeguards applied), to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team has been compromised.

Moreover, section 55, Article IV – Objectivity and Independence - states, “A member in public practice should be independent in fact and appearance when providing auditing and other attestation services”.

While many different circumstances may pose threats to independence, the AICPA stated that, “seven broad categories of threats should always be evaluated when threats to independence are being identified and assessed. They are self review, advocacy, adverse interest, familiarity, undue influence, financial self-interest and management participation threats” (100.12).

Threats to KPMG’s independence, when auditing DOJ, included adverse interest and undue influence. Adverse interest threats included “actions or interests between the member and the client that are in opposition, such as commencing or the expressed intention to commence litigation by either the client or the member against each other” (100.15). Clearly the litigation by the DOJ against KPMG falls within this threat. An undue influence threat

is an attempt to coerce management or other interested parties to coerce the member or exercise excessive influence over the member (100.17). While specific information concerning undue influence is not known, it appears the DOJ was in a position to threaten the livelihood of KPMG with the litigation. A single felony conviction would have caused revocation of KPMG's license and its demise. This is precisely what happened to Arthur Andersen. Undoubtedly, both the DOJ and KPMG were aware of this possibility.

The AICPA's conceptual framework allows for threats to independence if safeguards are in place to eliminate or reduce the threats. According to section 100.22, there are three broad categories of safeguards. The relative importance of a safeguard will depend on its appropriateness, in light of the facts and circumstances. The categories are:

- a. Safeguards created by the profession, legislation, or regulation
- b. Safeguards implemented by the attest client
- c. Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements

According to section 100.04, "threats are at an acceptable level when it is not reasonable to expect that the threat would compromise professional judgment". What possible safeguards could KPMG have in place to mitigate the threat of extinction by the DOJ while concurrently performing an audit of the DOJ? Due to the significance of the investigation and the size of the audit, how was independence in appearance maintained? One cannot fault KPMG for trying to survive the enormous power of the DOJ. Jobs for thousands of employees and clients would be disrupted with a single felony conviction. Its very survival was at stake. Even if KPMG wanted to withdraw from the audit, it is quite conceivable that the DOJ, as part of the "cooperation" requirement in the DPA, would not have allowed a change of auditors for fear of more bad publicity at the DOJ.

Criminal charges filed against former KPMG employees

The DOJ also indicted former employees of KPMG because of the alleged tax frauds admitted to by KPMG. However, the charges were dropped against many of the defendants. The dismissal was a consequence of the inappropriate actions of the DOJ in its zealous quest to prosecute the former employees.

In an opinion dated June 26, 2006 dismissing charges against former KPMG employees Judge Kaplan wrote, “The government violated the fifth and sixth amendments by causing KPMG to cut off payment of legal fees and other defense costs upon indictment” (p.39). He also wrote, “KPMG was extremely anxious to curry favor with the USAO by demonstrating how cooperative it could be” (p.33). Judge Kaplan also found that some of the actions of the DOJ “were not appropriate” (p.80). In describing these actions, Judge Kaplan wrote that the DOJ held “the proverbial gun” to KPMG’s head (p.2). Perhaps the DOJ used the same “proverbial gun” to obtain the DPA and/or audit reports.

It is an understatement to say that the DOJ has enormous resources to levy against an individual or entity. As pointed out by Judge Kaplan, no major financial services firm ever survived a criminal indictment (*USA v Stein*, p. 5). Arguably, it is easy to speculate that KPMG capitulated and signed the DPA in order to survive. Arthur Andersen stood on its principles and eventually won, but only in principle.

CONCLUSION

It is important to note that at the time of the DPA, the DOJ was in the spotlight for various scandals. It is easy to imagine that politics played a role for the DOJ to obtain an agreement from KPMG. The government wanted to portray itself as tough on corporate fraud. However, is it equally possible (and unsubstantiated speculation) that the DOJ coerced KPMG to write an acceptable audit report of the DOJ to prevent the disclosure of further scandals (e.g. financial or operational) against the department, its agencies, or former Attorney General (Mr.

Gonzalez). The author has no information of specific breaches by either KPMG or the DOJ. However, neither KPMG nor DOJ maintained independence in appearance.

If KPMG did commit fraud as alleged by the DOJ, was the DPA appropriate? What about protecting the public? Why should KPMG be allowed to practice accounting? In a search of disciplinary actions against CPA's by state boards of public accountancy, the author could not locate a single licensed CPA who admitted to fraud in the practice of public accountancy and maintained his/her license to practice. In each case, the CPA lost their license to practice.

Lastly, assume the DOJ paid KPMG's audit fees. Was the revenue stream generated by KPMG considered when determining the fines? Perhaps those same funds were returned to DOJ by KPMG to pay the DPA fines. In the alternative, maybe the DOJ used the DPA fines to pay KPMG's audit fees. The bottom line is that independence, in appearance, was lacking.

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