

News

FTX Collapse Puts Auditors in Crosshairs of Clients, Regulators

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- Auditors face allegations they missed red flags
- Extent of liability partly depends on contracts

By Nicola M. White

(Bloomberg Law) --

A lawsuit against FTX's auditors highlights potential legal risks the audit firms face for vetting the failed cryptocurrency exchange's books.

Prager Metis CPAs LLC and Armanino LLP were "willfully blind" to a pattern of "racketeering" at FTX, a customer who allegedly lost \$20,000 said in a **Nov. 23 lawsuit** in San Francisco federal court. The suit is expected to be the first of many as investors and regulators pore over the wreckage of the company to assign blame for billions of missing customer and creditor dollars.

As the gatekeepers of the company's financials, the auditors could be an easy target for customers and regulators alike, in part because they naturally draw attention when client companies implode.

There will be more lawsuits against the the auditors, said W. Robert Knechel, director of the International Accounting and Auditing Center at the University of Florida.

"You can't get blood from a turnip, but you can get money out of an audit firm," Knechel said.

Auditors are required to maintain a "professional skepticism" of their clients, including alertness to error and fraud, the investor's lawyers wrote in their complaint. "Neither Armanino nor Prager Metis did so here."

Prager Metis, which audited FTX Trading Ltd., and Armanino, which audited FTX US, didn't immediately respond to requests for comment.

It's unclear how much liability the auditors will have. A firm's contract with a client could guard it from losses over a certain amount. Audit firms also may be able to argue that investors didn't rely on the company's audited financials to decide whether to invest in or do business with FTX.

As a privately held company, FTX was not required to publicly share its audited financial statements, said Joseph Floyd, partner at Floyd Advisory, a financial and accounting consulting firm.

"When this is all made public, this may be deemed one of the worst audits ever, but the auditors may never write a check to any of the parties who suffered harm," Floyd said.

SEC Tools

Besides lawsuits, FTX's auditors may get some attention from the US Securities and Exchange Commission, which is **increasingly keen** to uncover **bad auditor** behavior.

"With the enhanced scrutiny on audit firms by the SEC, they're going to be very interested, and will use all the tools they have available to try to find an angle here," said Junaid Zubairi, chair of the government investigations group at law firm Vedder Price PC. "And I think they can."

An agency spokesperson declined to comment.

The SEC's biggest tool is its broad power to investigate potential securities laws violations. That power isn't limited to publicly traded companies or their auditors, Zubairi said.

The SEC's authority over auditors extends to any accountants who appear or practice in front of the regulator. Under the agency's Rule 102(e), the commission may censure a person or deny them the privilege of practicing before the SEC for a variety of reasons, including if they engaged in unethical or improper conduct or willfully violated securities laws, said Amy Jane Longo, partner in Ropes & Gray LLP's litigation and enforcement practice group.

The SEC also does not need to consider whether investors relied on the audited financials to take action against an auditor, Longo said.

"The SEC is acting for the market as a whole and for market integrity," Longo said. "Typically, the SEC isn't obliged to show reliance where it can show deficiencies in accounting standards and a relationship to securities law violations."

'Substantial Concerns'

The recent lawsuit points to FTX's bankruptcy filing, in which new CEO John J. Ray III said the company's books were a mess. Ray, who oversaw Enron Corp.'s liquidation, described a stunning lack of oversight or accountability at the company, from expense reports approved by emoji to the lack of a human resources or accounting department.

"Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here," Ray **said** in a bankruptcy court submission.

Ray specifically called out the auditors, citing "substantial concerns as to the information presented in these audited financial statements," particularly for the part of the business audited by Prager Metis, a firm that in January announced it was the first CPA firm to open a headquarters in the metaverse.

"As a practical matter, I do not believe it appropriate for stakeholders or the court to rely on the audited financial statements," Ray said in the filing.

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