

The Reach Too Far: SEC Sues Over Botched School Audit

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As I have written recently, accounting firms that “reach” for more business and/or for types of business that “exceed their grasp” court disaster – in terms of the quality of the professional services rendered, the damage to the firms’ professional reputations, and the financial losses the firms suffer as a result.

My July 24, 2023 blog “[Why 'Ask Marcum'?](#)” tells the tale of an accounting firm aggressively seeking to grow, which became the “go to” firm for Special Purpose Acquisition Companies (“SPAC”) deals only to fail mightily in trying to keep up with the workload, and ended up settling an enforcement action brought by the U.S. Securities and Exchange Commission (“SEC”) including payment of a civil penalty of \$10 million to the SEC and \$3 million to the Public Company Accounting Oversight Board (“PCAOB”), as well as material restrictions on its ability to take on new work. Then, as recounted in my Aug. 29, 2023 blog “[Eating Crowe](#),” the SEC sanctioned one of the world’s largest accounting firms for trying to provide audit services in a SPAC financing that resulted in a total loss for investors, for which the accounting firm paid \$11.5 million in damages to the investors, in addition to disgorging its fees and paying a civil penalty of \$750,000. The accounting firm also forfeited its registration with PCAOB and accepted the imposition of major conditions to be met before it could reapply to register with PCAOB. As a consequence, the accounting firm is not eligible to audit public companies traded on the American capital markets.

A particular area of audit malperformance involves municipal entities, especially school districts. I have previously written extensively about the regulatory structure of the municipal security market, e.g., in my Sept. 22, 2020 blog “[SEC Focus on Municipal Securities](#),” which includes quite a number of enforcement actions arising out of the inadequacy of disclosure by municipal issuers and their advisors. In my June 27, 2022 blog “[Serving the Public?](#)” not only do I discuss a number of violative failures and misstatements, including some involving school systems, but also the creation in 2010 of the Public Finance Abuse Unit within the SEC’s Division of Enforcement, reflecting both the growing volume of cases and the seriousness of the misdeeds.

Two of my other blogs scrutinize the failures of purportedly well-trained and dedicated accountants to report accurately on the financial status of the schools involved: see my March 2, 2021 blog “[Being Held Accountable](#)” about the audit by KPMG of the now-defunct College of New Rochelle; and my April 28, 2022 “[Failing Grades](#),” involving an auditor of a school district who missed both the rapid deterioration of that district’s finances and the steps taken by the district’s chief financial officer to conceal that decline. There is apparently something about taking on an engagement to audit a school

system that beguiles even experienced accountants into inattention.

Now comes another, similar case, where the intersection of efforts to expand revenue, coupled with the absence of relevant experience, made a purported audit of a school system both rushed and incomplete. Interestingly, we have some substantial admissions by the principal of the defendant accounting firm. The Complaint (the “Complaint”) filed by the SEC in the Federal District Court for the Northern District of Georgia, Atlanta Division, on Sept. 27, 2023, recites that 67-year-old Luther C. Speight III (“Speight”) of Luther Speight & Company, LLC (“LSC”) of New Orleans, Louisiana, admitted during the SEC investigation that:

1. neither he nor LSC had any experience in auditing any issuer of municipal bonds, including any school district; and
2. that this engagement “was the largest audit engagement in LSC’s history.” LSC’s proposal to the school district (in response to a Request for Proposal for Professional Auditing Services) represented that each member of the audit team had lengthy governmental accounting and audit experience, including Speight’s 35 years of such experience.

Speight also admitted that LSC “originally intended to partner with a larger firm...but was unable to find such a partner.”

LSC is a three-office accounting firm in Atlanta, Memphis, and its headquarters in New Orleans, with under 50 employees and annual revenue of some \$5 million. LSC was founded in 1987 and, according to its website, has been federally designated as a “disadvantaged business enterprise.” LSC is also listed as a Member firm of the New Orleans Regional Black Chamber of Commerce. As required by Louisiana law, the Board was and is required to “submit audited financial statements to the ... [Louisiana Legislative Auditor (“LLA”)] within six months of ...[the school district’s] fiscal year-end.” The school district’s fiscal year ends on June 30, so the 2019 audited financial statements were due at the LLA by Jan. 2, 2020 (reflecting a brief extension of time due to the holidays). Although the Complaint does not name the school district, it is sizable, and serves a parish in Louisiana. The Board (the “Board”) of the school district reported that as of June 2019, it had revenue of \$1.35 billion; expenses of \$547.1 million; and long-term liabilities of \$198.2 million, including bonds totaling \$99 million. On July 3, 2019, LSC was engaged by the Board to audit the 2019 fiscal year financial statements and future financial statements. LSC began audit work in August 2019, supervised by Speight, after LSC represented in its engagement letter that it expected to issue its audit report by Dec. 15, 2019.

The Complaint recites in considerable detail a number of missteps by LSC in conducting and documenting the audit, including giving a professional opinion that “[LSC]... conducted ...[the] audit in accordance with auditing standards accepted in the United States of America...,” when such was not the case. Ironically, the LSC website extols the firm’s “Commitment to Quality Service.” Unfortunately for both LSC and the school district, the actual audit failed to meet those applicable auditing standards. The first failure was not completing the audit on time. On Jan. 2, 2020, Speight signed the audit report, but he backdated it to Dec. 18, 2019. In the course of the SEC investigation, Speight asserted that “LSC had substantially completed its fieldwork and audit work.” In fact, the audit work was deficient in several material areas. The financial statements misreported certain revenues and expenses, especially in connection with a “Pass-Through Fund” that received city tax revenues to finance operations of charter schools within the district. That deficiency was identified on Jan. 9, 2019, by employees of the charter schools.

The second failure was when LSC did not obtain a signed management representation letter from the Board until Jan. 14, 2020, i.e., after issuing the audit report. And LSC did not include in the financial statements an after-occurring event, despite the requirement to do so under the applicable audit standard. That after-occurring event was the issuance by the district in November 2019 of \$40 million of Revenue Anticipation Notes (“RAN”). During a meeting with the Board in mid-January 2020, Speight “admitted that LSC ran out of time to do the additional procedures that would have allowed them to identify and correct the ...[“Pass-Through Fund”]” and other errors. LSC also had to include “certain missing tables and pages to the financial statements” and remove “certain duplicate pages.”

Information about municipal issuers is published on the Electronic Municipal Market Access (“EMMA”) created in 2008 and operated by the Municipal Securities Rulemaking Board, an affiliate of the SEC. See again my Sept. 22, 2020 Blog “SEC Focus on Municipal Securities.”

On Jan. 6, 2020, the Board posted its 2019 financial statements with the LSC audit report on EMMA. Subsequently, on Mar. 6, 2020, the Board posted the revised financial statements on EMMA. LSC did not issue a revised audit report specifying what errors had been identified and what revisions had been made. LSC also failed to take steps to inform any recipient of the Jan. 6, 2020 financial statements that the statements had been revised. On Jan. 14, 2020, the LLA accepted the revised financial statements with the original audit report (without even a date change).

The revised financial statements still failed to comply with applicable accounting standards, including not disclosing the \$40 million in November 2019 RAN issuance. The Complaint also details the failures of LSC to document the audit adequately, including signing work papers to identify who did the work and specifying the date it was performed, and who reviewed those papers. In addition, quite a number of documents reviewed by LSC, including the management representation letter, were received by LSC AFTER the date of issuance of the audit report. All of this led the SEC to plead in the Complaint that “Speight and LSC’s quality control procedures were deficient.” The Board similarly concluded that LSC had not met its professional obligations, and in late February 2020, the Board terminated the engagement of LSC having paid LSC \$135,860 for the 2019 audit.

The Complaint avers that Speight and LSC knew (or should have known) that the Board would use the financial statements and audit report as part of disclosures made in connection with future bond offerings, as the 2017 and 2018 financial statements reflected issuances of municipal bonds. In addition, LSC knew that the Board was seeking approval from the Louisiana State Bond Commission (“LSBC”) to issue new bonds in 2020. See again my June 27, 2022 blog “[Serving the Public?](#)” for a discussion of the LSBC and its role in municipal finance in Louisiana (attempting to prevent the fraudulent issuance of bonds, in that case to finance a water and sewer project).

The Board submitted the revised 2019 financial statements and the LSC audit report to the LSBC. The SEC asserts that the LSBC would not have approved the Board’s issuance of \$120 million in RANs to a bank investor had the LSBC known that the audit was not conducted in accordance with applicable accounting standards. Further, the Complaint alleges that the failure to disclose the lack of “a...compliant audit was important to the investor’s investment decision.”

In the Complaint, the SEC alleges that Speight and LSC violated Sections 17(a)(2) and (a)(3) of the Securities Act of 1933, as amended, by facilitating the sale of securities by the use of untrue statements and material omissions and by engaging in business practices that operated as a fraud on the purchasers of those securities. Further, the SEC sought a permanent injunction against future violations, including specifically barring Speight and LSC from participating in an audit of any financial

statements that “should reasonably” be expected to be posted on EMMA. The Commission also sought disgorgement of ill-gotten gains together with prejudgment interest and the imposition of a civil penalty. The SEC Press Release from Sept. 29, 2023, reports that the defendants settled the case, consenting to the injunction, including the bar to EMMA-related audits, and agreed to:

pay disgorgement and interest totaling \$12,826; and

pay civil penalties of \$20,000 from Speight and \$10,000 from LSC.

The Press Release also notes that the SEC investigation was conducted by the Public Finance Abuse Unit of the SEC’s Division of Enforcement.

While the relative leniency of the financial sanctions imposed on Speight and LSC may seem surprising, several factors may help to explain those results:

- First, the investor bank apparently did not suffer any financial harm from purchasing the \$120 million in RANs (i.e., there was no “loss causation”);
- Second, the bar to any future audits of any entity whose security would be posted on EMMA is potentially a very substantial penalty (and the bar also means that Speight and LSC will not be in a position to do something similar in the future);
- Third, this was pretty clearly a case not of design, but rather of inexperience and neglect;
- Fourth, Speight was both forthright and, apparently, remorseful about the audit failures.

The relative size of LSC and its status as a “disadvantaged business enterprise” may also have influenced the Commission in deciding on sanctions. In any event, this case evidences quite graphically the need not to take on professional tasks beyond the experience and capabilities of the audit firm.

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