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Recent Auditor Independence Cases Suggest SEC's "Operation Broken Gate" Is in Full Swing

BY MATTHEW P. BOSHER

As the glut of financial crisis cases approaches the end of the pipeline, the SEC and other regulators have inevitably shifted their attention to different targets. At least one of those new targets is an old one: accounting firms.[1]

In October 2013, SEC Chair Mary Jo White announced the launch of "Operation Broken Gate"—"an initiative to identify auditors who neglect their duties and the required auditing standards."[2] Around the same time, the Director of the Enforcement Division previewed a renewed "focus on auditors" and, in particular, independence violations.[3] And in February, the SEC's then-Chief Accountant also emphasized that auditor independence was a particular concern for the SEC staff.[4]

The last 18 months of enforcement activity demonstrate that the SEC was not bluffing. As set forth below, the SEC has recently filed multiple auditor independence cases and released a detailed report with warnings for firms that loan staff to their audit clients. Accounting firms should note the enforcement activity.

A. Overview of the SEC's Auditor Independence Rules

First, a quick refresher on the SEC's independence rules. Rule 2-01 of Regulation S-X requires auditors to be independent of their SEC audit clients, both in ap-

[1] *See* Andrew Ceresny, Director, SEC Division of Enforcement, Remarks at the American Law Institute Continuing Legal Education (Sept. 9, 2013) (describing the SEC Enforcement Division's "pivot away from the financial crisis cases and refocus on accounting fraud"), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539845772.

[2] Mary Jo White, Chair, Securities and Exchange Commission, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539872100.

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[3] Ceresny speech, *see* note 1, *supra.*

[4] Paul Beswick, Chief Accountant, SEC, presentation at the SEC Speaks Conference (Feb. 22, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540846980. The PCAOB is also focused on independence violations. In a speech to auditors on Oct. 29, 2014, a PCAOB member noted her surprise "regarding the continuing and pervasive independence" violations the PCAOB had uncovered. Jeanette M. Franzel, Board Member, PCAOB, Developments Related to Audits of Brokers and Dealers (Oct. 29, 2014), *available at* http://pcaobus/News/Speech/Pages/10292014_BDF.aspx. She warned auditors that "[i]t is unacceptable to 'push the envelope' on this issue that is central to the integrity of audits and has been settled for years." *Id.* And on Dec. 8, 2014, PCAOB Chairman James Doty reiterated that "The bedrock of audit quality is independence. . . . Adhering to independence requirements is critically important." Press Release, Public Company Accounting Oversight Board, PCAOB Announces Settled Disciplinary Orders Against Seven Audit Firms for Independence Violations When Auditing Broker-Dealers (Dec. 8, 2014), *available at* http://pcaobus.org/news/Releases/Pages/12082014_Enforcement.aspx

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pearance and in fact.[5] The SEC's independence rules are voluminous and complex, but the Office of the Chief Accountant has articulated four general principles relating to auditor independence:

- A relationship or service may not create a mutual or conflicting interest between the auditor and audit client.
- An auditor may not be in a position of auditing its own work.
- An auditor may not act as management or an employee of its audit client.
- An auditor may not be in a position of being an advocate for its client.[6]

Rule 2-01(c) contains a nonexhaustive list of services, arrangements and circumstances that violate the independence requirements. Prohibited non-audit services include:

- bookkeeping;
- financial information systems design and implementation;
- appraisal, valuation and actuarial services;
- internal audit outsourcing;
- management functions or human resources services;
- investment banking services;
- legal services; and
- expert services unrelated to the audit.

The rule also identifies prohibited relationships, including:

- employment relationships;
- contingent fee arrangements;
- direct or material indirect business relationships; and
- financial relationships such as credit/debtor and banking relationships.

In prosecuting auditor independence cases, the SEC typically invokes one or more of the following federal securities laws and SEC rules.

- Exchange Act Rule 10A-2 makes it unlawful for an auditor of an issuer not to be independent.[7]
- Rule 2-02(b) of Regulation S-X requires accountants to state whether audits were conducted in compliance with generally accepted auditing standards (''GAAS'').[8] GAAS require auditors to be independent; accordingly, a lack of independence may lead to a violation of GAAS, which may lead to a violation of Rule 2-02(b).
- Section 4C(a)(2) of the Exchange Act[9] and Rule 102(e)[10] of the Commission's Rules of Practice enable the SEC to censure or suspend professionals for ''improper professional conduct,'' which, in the SEC's view, includes independence violations.
- Issuers must file independent audit reports with their annual financial statements. To the extent the auditor is not independent, that report may be inaccurate and the SEC may charge the auditor with causing the issuer to file an inaccurate report.

B. Recent Cases

Recent auditor independence cases fall mainly into two broad categories: (1) cases relating to auditors providing prohibited non-audit services to clients or engaging in prohibited employment (or employment-like) arrangements, and (2) cases involving prohibited financial ties between an auditor (or its associated entities) and audit client (or its affiliates).

1. *Prohibited Non-audit Services and Employment Arrangements*

a. Action Based on FINOP Services to Audit Client[11]

On June 14, 2013, the SEC filed a settled administrative proceeding against an accounting firm, RRBB, and one of its partners, Brian Zucker. Zucker previously owned his own firm, which focused on providing financial and operations principal (''FINOP'') services to broker-dealer clients. In October 2011, Zucker's firm merged with RRBB. Several of Zucker's FINOP clients were RRBB audit clients. According to the SEC, after the firms merged, Zucker served as audit engagement partner for a broker-dealer client, while simultaneous providing FINOP services to the client.

The SEC concluded that the simultaneous services violated auditor independence rules in two ways. First, the FINOP services constituted prohibited non-audit services, including bookkeeping. Second, because, according to the SEC, a FINOP performs management-level responsibilities for a broker-dealer—including monitoring the broker-dealer's compliance with capital rules, approving financial reports submitted to regulators and supervision of back-office operations—Zucker's provision of FINOP services violated the prohibition on an auditor's performing decision making or supervisory services for audit clients.

RRBB and Zucker were both charged with causing the broker-dealer client's failure to file independently audited financial statements and with 102(e) violations. RRBB was censured and paid $12,000 in disgorgement and a $25,000 fine. Zucker was suspended from practicing before the SEC, with the right to apply for reinstatement after one year.

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[5] 17 C.F.R. § 210-2.01. The independence requirements apply to audits of broker-dealers as well.

[6] SEC Office of the Chief Accountant, Audit Committees and Auditor Independence (modified May 7, 2007), *available at* http://www.sec.gov/info/accountants/audit042707.htm.

[7] 17 C.F.R. § 240.10A-2.

[8] 17 C.F.R. § 210.2-02(b).

[9] 15 U.S.C. § 78d-3.

[10] 17 C.F.R. § 201.102(e).

[11] *In the Matter of Rosenberg Rich Baker Berman & Co., et al.*, SEC Administrative Proceeding Release No. 34-69765, 2013 WL 2898032 (June 14, 2013).

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b. Action Against Big Four Firm Based on Non-audit Services and Loaned Employee[12]

The SEC's Jan. 24, 2014, settled action against a Big Four firm reflects most vividly the SEC's focus on auditor independence. The SEC alleged that the firm violated independence rules in two principal ways.

First, the SEC alleged that the firm provided prohibited non-audit services to affiliates of two of the firm's audit clients. The prohibited services alleged included restructuring services, expert services, bookkeeping and payroll assistance. In one instance, an audit client became an affiliate of a non-audit client pursuant to an acquisition; the combination of the two clients created the alleged independence violation. The SEC's order emphasized the importance of examining any potential affiliation between audit clients and non-audit clients, an emphasis echoed in a speech by the SEC's Chief Accountant the following month: ''business combinations by either the issuer or the auditor can affect the independence analysis significantly.''[13]

Second, according to the SEC, the firm hired an employee of an affiliate of an audit client and then loaned him back to the affiliate to do the same work he had done as the affiliate's employee. The SEC concluded this arrangement violated independence rules because the Big Four firm employee ''acted as both a manager and an employee'' of the audit client's affiliate, and ''provided advocacy services for the affiliate.''[14] As a result, the SEC charged the firm with violating the prohibition on serving as an audit client employee.

The firm agreed to settle the matter by (i) paying $6.4 million in disgorgement and a $1.775 million penalty and (ii) retaining an independent consultant to review the firm's training and monitoring of compliance with independence requirements.

c. Report of Investigation Relating to Loaned Staff Arrangement[15]

The SEC also released a Jan. 24, 2014, Report of Investigation relating to charges it did not pursue. The focus of the Report was an arrangement pursuant to which a Big Four firm loaned junior staff to audit clients to assist in tax return preparation and other tax compliance work, and whether that arrangement violated the prohibition on an independent auditor acting as an employee of an audit client.

The firm defended the loaned staff engagements on the basis that (i) auditors are permitted to provide tax services to audit clients, and (ii) the loaned staff remained employees of the firm and were compensated by the firm. The SEC, on the other hand, pointed to evidence that the loaned employees (i) were supervised by audit client staff, (ii) performed the same work as employees of the audit client, (iii) worked exclusively at the audit client's place of business and (iv) used the audit client's resources to perform the loaned staff's work.

In the Report, the SEC conceded that a firm *can* provide tax services to its audit clients without impairing the firm's independence. But the SEC stated that, in addition to the prohibition on auditors serving as client employees, auditor personnel may not *act* as client employees either. In other words, an auditor may not do indirectly (acting as an employee) what it may not do directly (being an employee). The SEC instructed audit firms to consider carefully ''whether the relationship or service in question would cause the accounting firm's professionals to resemble, in appearance and function . . . the employees of the audit client.'' The SEC pointed to the degree of control the audit client exercises over a firm's loaned staff as a key factor in whether the arrangement compromises the firm's independence.

In conclusion, while the SEC did not bring charges against the firm in this instance, the SEC stated an apparent presumption that ''[l]oaned staff arrangements, by their nature, appear inconsistent with the prohibition against acting as an employee.'' The SEC seems to have drawn a distinction between an auditor's provision of permissible, non-audit *services* and provision of *personnel*.

d. Action Against Issuer Based on Retention of Auditor as Bookkeeper[16]

On April 15, 2014, the SEC filed a contested administrative proceeding against a registered investment adviser and its principals. While the main allegations related to the adviser's receipt of undisclosed revenue-sharing fees, the SEC also charged the adviser and its principals with making false statements relating to the independence of a fund's auditor. According to the SEC, the adviser retained an auditor both to prepare *and* audit a fund's financial statements—a violation of the prohibition on an auditor providing bookkeeping services to its SEC client, as well as the general principle that an auditor is not independent when it audits its own work.

e. Action Against Big Four Firm Based on Lobbying Services for Audit Clients[17]

On July 14, 2014, the SEC filed settled charges against a Big Four firm based on alleged lobbying work performed by a subsidiary of the firm for two audit clients. The SEC alleged that the lobbying subsidiary interacted with members of Congress on the audit clients' behalf relating to legislation that potentially impacted the clients. The SEC cited the preliminary note to Rule 2-01, counseling against a relationship that ''places the accountant in a position of being an advocate for the audit client.'' The SEC also suggested that, while it had written independence guidance relating to the provision of lobbying services to the audit client, the Big Four firm should have provided ''formal, in-person training specifically tailored to the policy.'' The firm agreed to pay $4.1 million to settle the matter.

f. Audit Firm Resigns After Concluding Provision of Personal Tax Services to Audit Client Executive Impaired Firm's Independence[18]

On Oct. 15, 2014, Nxt-ID, Inc., filed an 8-K stating that its independent auditor had concluded it was not

[12] *In the Matter of KPMG LLP*, SEC Administrative Proceeding Release No. 34-71389, 2014 WL 265811 (Jan. 24, 2014).

[13] Beswick speech, *see* note 4, *supra*.

[14] *In the Matter of KPMG LLP*, *see* note 13, *supra*.

[15] Securities Exchange Act of 1934 Release No. 71390, 2014 WL 555653 (Jan. 24, 2014).

[16] *In the Matter of Total Wealth Management, Inc.*, SEC Administrative Proceeding Release No. 33-9575, 2014 WL 1438614 (April 15, 2014).

[17] *In the Matter of Ernst & Young LLP*, SEC Administrative Proceeding Release No. 34-72602, 2014 WL 3401161 (July 14, 2014).

[18] Nxt-ID, Inc., Current Report (Form 8-K) (Oct. 15, 2014).

independent and would resign. According to the filing, the audit firm's conclusion was based on its provision of personal tax services to an executive of Nxt-ID. Nxt-ID also announced that, because of the audit firm's lack of independence, the firm's review work on the financial statements for the quarter ended June 30, 2014, should not be relied upon. Nxt-ID indicated that it would engage a new independent auditor and that the new firm would review the June 30, 2014, financial statements.

g. Actions Against Fifteen Firms Based on Preparation of Audit Clients' Financial Statements[19]

On Dec. 8, 2014, the SEC filed settled actions against eight audit firms, and the PCAOB filed settled actions against seven firms. The common allegation in all fifteen cases was that the audit firms assisted in the preparation of financial statements and/or notes to the financial statements for their audit clients, all of which were broker-dealers. The SEC's release quoted an Enforcement Division official: ''To ensure the integrity of our financial reporting system, firms cannot play the roles of auditor and preparer at the same time.''[20] Each firm was censured and agreed to undertake certain remedial measures relating to independence requirements. Most of the firms also paid a penalty.

The regulators' focus on audits of broker-dealers was not surprising; on Oct. 29, 2014, a PCAOB member warned a group of broker-dealer auditors that PCAOB ''staff continue to identify apparent independence violations regarding the auditor's involvement in the preparation of financial statements. This is disappointing, as we and the SEC staff have been clearly conveying . . . that this is prohibited by SEC rule, and yet the practice persists.''[21] Nor was the principle at issue in these actions—that an auditor may not audit its own work—novel.

What is noteworthy is the regulators' expansive definition of what it means to ''prepare'' financial statements. In one case, for example, the SEC alleged little more than that the auditor made suggestions for the grouping of accounts for incorporation in the financial statements. (The alleged violation was less subtle in other instances such as when the auditor's engagement letter stated ''as part of our engagement, we will prepare the audited financial statements.'') The PCAOB release summarized the prohibited conduct as preparation of the client's ''financial statements, by drafting them outright or by some combination of aggregating, revising, classifying, or supplementing financial information obtained from their audit clients.''[22]

[19] Press Release, U.S. Securities and Exchange Commission, SEC Sanctions Eight Audit Firms for Violating Auditor Independence Rules (Dec. 8, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543608588#.VIdLL01OWUk; Press Release, Public Company Accounting Oversight Board, *see* note 4, *supra*.

[20] Press Release, U.S. Securities and Exchange Commission, *see* note 19, *supra*.

[21] Franzel speech, *see* note 4, *supra*.

[22] Press Release, Public Company Accounting Oversight Board, *see* note 4, *supra*.

2. *Prohibited Financial Ties Between Auditor and Audit Client*

a. Action Based on Tipping by Big Four Firm Partner[23]

Scott London was a Big Four firm partner who provided inside information regarding his firm's clients to a friend. He pleaded guilty to insider trading charges in 2013 and was sentenced to 14 months in prison.

On Sept. 27, 2013, the SEC filed a settled administrative proceeding against London based on his violations of auditor independence rules. According to the SEC, London gave his friend inside information relating to five of his firm's audit clients in exchange for cash, jewelry and concert tickets. The SEC charged London with violating the rule against an auditor holding a financial interest in an audit client. The SEC reasoned that, inasmuch as London received valuable consideration for the information he provided, and knew or believed his friend intended to trade on the information, London possessed ''prohibited financial interests'' in the audit clients whose inside information he revealed.

The SEC concluded that London caused his firm to violate the independence rules and caused the firm's clients to file financial statements that were not independently audited. London was barred from practicing before the SEC.

b. Action Based on Audit Client ''Loans'' to Audit Firm Partner[24]

On May 20, 2014, the SEC filed a settled action against a former Big Four firm partner for violating the rules relating to financial ties. During a time in which the former partner participated in his firm's audit of a casino gaming company, the partner sought and received markers from a casino operated by the audit client. Certain of the markers remained outstanding for a period of time, and, ultimately, the partner defaulted on $110,000. According to the SEC, inasmuch as the markers operated as a line of credit, they violated Rule 2-01(c)(1), which specifically prohibits, with some exceptions, a loan ''to or from an audit client.'' The former partner agreed to a suspension from appearing and practicing before the SEC, with the ability to apply for reinstatement after two years.

c. Action Based on Audit Client's Investment in Audit Firm's Alleged ''Associated Entity''[25]

On Sept. 25, 2014, the SEC filed a settled administrative proceeding against a broker dealer based on its investment in a company that the SEC claimed was ''an associated entity'' of the broker-dealer's independent auditor. According to the SEC's Order, the auditor had a contract with a separate and independent service provider, pursuant to which the auditor leased certain services to perform accounting work. In exchange, the service provider received a portion of the auditor's rev-

[23] *In the Matter of Scott London, CPA*, SEC Administrative Proceeding Release No. 34-70549, 2013 WL 5405367 (Sept. 27, 2013).

[24] *In the Matter of James T. Adams, CPA*, SEC Administrative Proceeding Release No. 34-72198, 2014 WL 2090701 (May 20, 2014).

[25] *In the Matter of Tradebot Systems, Inc.*, SEC Administrative Proceeding Release No. 34-73222, 2014 WL 4756213 (Sept. 25, 2014).

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enue. The SEC took the position – with no detailed discussion or analysis – that the auditor and the service provider, a public company, were ''associated entities,'' and, accordingly, would be ''viewed as a single entity for Commission auditor independence purposes.'' When the broker-dealer traded in the stock of the service provider, the SEC claimed that the auditor's independence was impaired. The broker-dealer agreed to pay a $50,000 penalty to settle the case.

3. *Other Cases of Interest*

a. Failure to Rotate

In the last year, the SEC filed two independence-related cases based on failures to comply with the Sarbanes-Oxley requirement that lead audit partners rotate off engagements after five consecutive years.[26] The PCAOB filed a case on the same basis.[27] The fact pattern in these cases was straightforward: the same accountant served as lead auditor for more than five years; as a result, his firm was not independent with respect to the audit services he provided beginning in the sixth year.[28] There was a twist in the most recent SEC case: according to the SEC, the accountant attempted to evade the five-year rotation requirement by assigning a non-CPA, unqualified employee to serve as lead audit partner in the sixth year, while the accountant continued to function as lead audit partner. In that case, the accountant and his firm were censured and fined, and the accountant was suspended from practicing before the SEC for at least one year. In the earlier SEC case, the individual accountant was suspended from practicing before the SEC for at least five years. In the PCAOB case, the audit firm's registration was revoked and the individual accountant was barred from being associated with a registered firm for at least three years.

b. New York DFS Gets Into the Act

The New York Department of Financial Services (''DFS'') also took action against the consulting arms of two Big Four firms in the last 18 months.[29] While not auditor cases, the DFS actions underscore the general regulatory scrutiny on accounting firms and independence issues.

In the first case, filed in June 2013, the DFS alleged that the Big Four firm was retained by a DFS-regulated bank to review the bank's anti-money laundering processes and prepare a report to the DFS. According to DFS, the firm's consultants became too cozy with bank management and acquiesced to the bank's wishes in removing certain language from the report to the DFS. DFS also criticized the firm for sharing with the bank information relating to other firm clients. In settling the DFS action, the firm agreed to a $10 million fine, a one-year suspension from consulting work for DFS-regulated banks, and internal reforms.

The second case, filed in August 2014, was similar. There, DFS claimed that the Big Four firm was retained by a DFS-regulated bank to prepare an independent, objective report regarding the bank's compliance with rules relating to sanctioned nations. As in the 2013 case, DFS alleged that the firm gave in to pressure from the bank to alter the firm's report to DFS in a way that sanitized certain conclusions. In a public statement on the matter, the New York Superintendent of Financial Services accused the firm of bowing to ''pressure [from bank executives] to whitewash a supposedly 'objective' report to regulators.'' In settling the matter, the firm agreed to a $25 million fine, a two-year suspension from consulting work for institutions regulated by DFS, and internal reforms.

C. What Have We Learned From Eighteen Months of Enforcement Activity?

Some lessons can be drawn from the enforcement activity to date in 2014:

- The SEC appears to be intensely focused on the provision of prohibited non-audit services to audit clients. PCAOB members have repeatedly raised concerns in this area as well. Firms should understand the services that are permitted and those that are not. The SEC has also suggested that training related to the independence rules should be formal, in-person, and tailored to specific risks.
- Auditors of broker-dealers must understand that the independence rules apply to them as well and that the SEC and PCAOB are watching. In particular, the regulators are focused on any assistance provided by the auditor in the preparation of its broker-dealer client's financial statements.
- Technically, an independent auditor may loan staff to its client and clearly the auditor may provide tax services to its client. But if the loaned staff *looks like* a client employee, regardless of the services provided, the SEC may conclude the arrangement violates the independence rules.
- Firms must be vigilant about any financial ties between their auditors and audit clients. Moreover, the *London* case suggests that the SEC views the concepts of financial interest and financial relationship broadly.
- Firms should know their client's affiliates. In particular, firms should monitor mergers and acquisitions involving clients in case an audit client and non-audit client become affiliates. As noted above, the SEC's Chief Accountant emphasized earlier this year that ''business combinations by either the issuer or the auditor can affect the independence analysis significantly.''
- Firms should know their own ''associated entities.'' As demonstrated in the enforcement action filed in September 2014, the SEC views ''associa-

[26] *In the Matter of John Kinross-Kennedy, CPA*, SEC Release No. 3520, 2013 WL 6705181 (Dec. 20, 2013); *In the Matter of Berman & Company, et al.*, SEC Release No. 3592, 2014 WL 5408488 (Oct. 24, 2014).

[27] *In the Matter of Jeffrey & Co., et al.*, PCAOB Release No. 105-2014-005 (May 6, 2014).

[28] Another development in 2014 relates to the PCAOB's consideration of a requirement that issuers rotate audit *firms* every few years. On Feb. 5, 2014, the PCAOB Chair informed the SEC that ''[w]e don't have an active project or work going on within the board to move forward on a term limit for auditors.'' Vincent Ryan, *PCAOB Abandons Auditor Rotation*, CFO.com, Feb. 6, 2014, ww2.cfo.com/auditing/2014/02/pcaob-abandons-auditor-rotation/. Accordingly, it appears the concept is dead (for now).

[29] *See* New York State Department of Financial Services Press Releases dated June 18, 2013 and Aug. 18, 2014, *available at* http://www.dfs.ny.gov/about/news.htm.

tion'' for independence purposes as much broader than legal affiliation.

- Audit committee members should also understand the auditor independence rules and the SEC's recent zeal for enforcing them. The Sarbanes-Oxley Act made audit committees responsible for overseeing the auditor, including monitoring of independence issues and approval of any non-audit services. Plus, as demonstrated above, independence violations can cause a serious problem for an issuer inasmuch as the violation may cause the audit report filed along with the issuer's financial statements to be inaccurate. Audit committee members should engage in constant dialogue and analysis regarding auditor independence.

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