# The SEC's View of Auditor Independence

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Financial statement integrity and investor confidence form the core of the Securities and Exchange Commission (SEC)'s auditor independence rules.[1] Very generally, these rules provide that independence is impaired if the accountant's judgment is not objective or impartial.[2] In 2002, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB) to oversee auditors of public companies to protect investors by promoting fair and independent audit reports.[3] Sarbanes-Oxley also amended or affected certain auditor independence rules concerning, among other things, employment relationships and prohibited non-audit services. Overall, the SEC's auditor independence rules are strict, complicated, and should be taken very seriously. A violation of these rules can result in violations of not only the rules themselves, but also the federal securities laws.

Earlier this year, the SEC filed two unrelated actions on consecutive days charging auditors with violations of the auditor independence rules. The first matter, a strongly worded administrative order, underscored the potential severity of not complying with these rules. *See In re Sims*, Admin. Proc. File No. 3-13410 (Mar. 17, 2009).[4] Indeed, the SEC made very clear in *Sims* that seeking employment with an audit client while continuing to work on that client's engagement is not permitted under the rules, and that such conduct may also violate the federal securities laws and lead to sanctions under Rule 102(e) of the SEC's Rules of Practice. The second matter involved federal district court allegations against the auditors of Bernard Madoff's broker-dealer firm and reinforced the SEC's view that legitimate audits require, among other things, auditor independence. *See SEC v. Friehling*, Lit. Rel. No. 20959 (Mar. 18, 2009).

### *Sims Allegations and Consequences*

In *Sims*, the audit partner of an international accounting firm engaged in employment discussions over an eight month period with an audit client, a foreign private issuer whose American Depository Receipts were listed on the New York Stock Exchange. He allegedly had multiple discussions about becoming the chief accounting officer of a back-office organization owned by the audit client — an organization that was to become responsible for the financial reporting of the clients' U.S. operations. During this same period, he worked on the audit engagement and was responsible for auditing the financial statements of the audit clients' U.S. operations. Further, the audit partner allegedly concealed these employment discussions from his accounting firm until his employment negotiations were nearly complete and falsely claimed that he had ceased working on the audit after first being approached about possible employment.

After the filing of the clients' annual report, independence concerns were raised due to the employment discussions. As a result, the audit client self-reported the matter

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to the SEC and instructed its other auditor, who was jointly responsible for the audit, to perform additional audit procedures so that it could issue a new audit opinion as the audit client's sole auditor - these procedures, however, did not detect any errors from the work previously performed by the audit partner.[5] The audit client then filed an amended audit report.

As a result of the alleged conduct, serious consequences resulted for the audit partner. Specifically, the SEC barred him from appearing or practicing before the agency for at least three years and entered a cease and desist order against him. The accounting firm was not charged in this matter. The sanctions imposed by the SEC against the audit partner were based on the following findings:

- Violations of current (and previously existing) professional independence standards for auditors, which require an auditor who is considering employment by an audit client to promptly notify the audit firm and remove themselves from the audit of that client;[6]
- Aiding and abetting the audit clients' violations of Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-1 thereunder, which require issuers to file annual reports containing financial statements certified by independent public accountants;
- Aiding and abetting an affiliated audit firms' violations of Regulation S-X, Rule 2-02(b)(1), which prohibits stating that an audit was conducted in accordance with PCAOB standards when it was not — since the audit partner lacked independence, the audit was not conducted in accordance with such standards; and
- Engaging in improper professional conduct under Rule 102(e) of the SEC's Rules of Practice — for violating the auditor independence rules in, at least, a reckless manner — and by willfully aiding and abetting violations of the federal securities laws.

*Madoff's Broker-Dealer Auditor*

In a more extreme and high profile context, the SEC charged the auditors of Bernard Madoff's broker-dealer firm with securities fraud for falsely representing they had conducted legitimate audits. Amongst numerous alleged violations, the SEC charged the auditors with violating auditor independence requirements and for falsely representing to the SEC, other regulators, and customers that they were independent of the broker-dealer.[7]

Specifically, the SEC alleged that the auditor and his family members had held accounts with Madoff's broker-dealer for many years and that these accounts exceeded $14 million near the end of 2008.[8] The auditor independence standards require an auditor to be free from any obligation to or interest in the client, its management, or its owners.[9] Moreover, auditor independence is impaired when an accountant has a brokerage account with a broker-dealer that is an audit client, if the value of assets in the accounts exceeds $500,000, the amount that is subject to a Securities Investors Protection Corporation advance.[10] Since the accounts of Madoff's broker-dealer auditor and his family allegedly exceeded $500,000, the SEC claimed that the auditor violated the independence rules.

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According to the SEC, the auditor independence rules were also violated because the auditor performed bookkeeping functions for Madoff's broker-dealer, including the preparation of the firm's financial statements. Under the rules, an auditor is not independent if it maintains or prepares the financial statements or accounting records that will be subjected to audit procedures.[11]

*Conclusion*

The SEC's auditor independence rules, including the changes implemented under Sarbanes-Oxley, are very strict. In addition, the message sent by the SEC in the *Sims* and *Friehling* actions is quite clear — auditor independence is of paramount importance and should be taken very seriously. The SEC will not ignore any conduct, particularly egregious conduct, which results in impaired auditor independence. Moreover, in the current environment of heightened regulatory scrutiny, the SEC's focus on auditor independence issues will likely continue.

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[1] *See* John T. Bostelman, *The Sarbanes-Oxley Deskbook*, §14:1.1 (2009).

[2] *Id.*

[3] *See* http://www.pcaobus.org/About_the_PCAOB/index.aspx. Interestingly, the United States Supreme Court will soon review arguments in a case — *Free Enterprise Fund v. PCAOB* — concerning the constitutionality of the PCAOB and the Sarbanes-Oxley Act.

[4] *Sims* was a settled administrative proceeding in which the Respondent neither admitted nor denied the findings in the SEC Order.

[5] The audit partner's firm was a member of an international audit and advisory organization that had a worldwide network of member firms and joint venture partnerships. One of these member firms was jointly responsible for the audit and issued the joint audit opinion with another accounting firm.

[6] *See* PCAOB Rule 3600T; AICPA Code of Professional Conduct ET Section 101; Independence Standards Board Independence Standard No. 3.

[7] *See SEC v. Friehling, Complaint*, S.D.N.Y. 09-CV-2467 (March 18, 2009).

[8] *Id.*

[9] *Id.* (citing AU Section 220.03; AICPA Code of Professional Conduct, ET Section 101).

[10] *See* Regulation S-X, Rule 2-01(c)(1)(ii)(C)(2), which applies to broker-dealer audits under Rule 17a-5(f)(3) of the Securities Exchange Act.

[11] *See* Regulation S-X, Rule 2-01(c)(4)(i).

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