

Implications for Issuers from Recent Auditor Independence Enforcement Cases

September 26, 2016 | Client Update | 4-minute read

The SEC recently found that EY violated the auditor independence rules in two cases based on the audit partners' close personal relationships with members of the issuer finance teams. In addition to a specific list of prohibitions, the SEC rules on auditor independence includes a catch-all that an accountant is not independent if a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment. We focus here on the consequences of those cases for issuers, including additional inquiries that audit firms may pose to management regarding their knowledge of any personal relationships between their employees and the engagement team.

In one case, the audit partner and the chief accounting officer maintained a personal and romantic relationship for several years, beginning in 2012, which they kept a secret from both their employers and colleagues. The chief accounting officer signed management representation letters that he had no knowledge of any facts or circumstances that would prevent the audit from qualifying as independent, and the audit partner participated in making representations to the issuer that the firm was independent.

Employees within the issuer's accounting and treasury departments harbored suspicions and told the EY coordinating partner, who oversaw the audit partner, that there may be an inappropriate personal relationship between the audit partner and the chief accounting officer. Although the EY coordinating partner agreed verbally, without conducting any further inquiries to either EY or the audit partner, he authorized release of the audit firm's report for the issuer's 2014 Form 10-K.

The relationship only came to light after one of the issuer's employees made an internal whistleblower complaint to the issuer in June 2014. In addition to violating the auditor independence rules, the SEC determined that the audit firm and both parties caused the issuer to violate Exchange Act requirements to file proper annual and periodic reports. The firm withdrew its audit reports on the issuer's 2013 and 2013 financial statements and the issuer had to hire another firm to re-audit those years.

In the other case, after an issuer informed EY that it was considering changing audit firms in 2010, the audit firm replaced the audit team. The new coordinating partner was fully aware that his role would include "mending" the firm's relationship with the issuer. Over the course of three years, the coordinating partner developed a relationship with the CFO and members of the CFO's family that ultimately led to seven out-of-town trips to Wisconsin, South Carolina and Nashville that involved spouses, siblings and children, numerous overnight stays in each other's primary residences and vacation homes, multiple golf outings and loads of professional football and hockey games, all of which amounted to over a hundred thousand dollars in expenses.

Some of the sports tickets were obtained through EY, but as the SEC order noted, the "majority of these entertainment-related expenses were ultimately billed to the [i]ssuer as audit expenses." Expenses that were classified as "entertainment" in internal EY spreadsheets were classified as "meals" in the spreadsheet given to the issuer, and a senior issuer employee who worked for the CFO began asking for more detail about those expenses that it was getting charged in 2014.

EY's policies require that activities with clients to include a "valid business purpose" with expectations that "meaningful business discussions" will take place and forbade gifts or hospitality that are beyond what is customary. The SEC, however, still faulted the audit firm for ignoring various red flags, such as the fact that two senior EY partners noted back

in 2012 that the coordinating partner's expense spending was double that of the next highest individual but did not investigate, and there was no follow-up responses to the issuer's questions about the expenses it was billed in 2014.

EY already had policies and procedures assessing their employees' independence from audit clients, which included training and certification and addressed possible familial, employment and financial relationships that are expressly prohibited under SEC rules. As part of the remedial efforts from both cases, additional procedures have been instituted that will require the audit firm's engagement team members to ask management of an issuer whether they are aware of any "close relationships" between members of the audit engagement team and any individuals employed by "or associated with" the issuer.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Ning Chiu

+1 212 450 4908

ning.chiu@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.